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# CRYSTAL WORLD MARKETS

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COMMENT

July 7, 2008

Mr. David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street NW  
Washington, D.C. 20581

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Re: Concept Release on the Appropriate Regulatory Treatment of Event  
Contracts, 73 *Fed. Reg.* 25669 (May 7, 2008)

Dear Mr. Stawick:

Crystal World Markets (CWM) welcomes the opportunity to respond to the Commodity Futures Trading Commission's ("Commission") request for comment on the appropriate regulatory treatment of financial agreements offered by markets commonly referred to as event, prediction or information markets. "Concept Release on the Appropriate Regulatory Treatment of Event Contracts," 73 *Fed. Reg.* 25669 (May 7, 2008) ("Concept Release"). The Commission, in its Concept Release, requested comment specifically on the following topics: 1) The public interest in trading such contracts; 2) the Commission's jurisdiction with respect to such contracts; 3) how the Commission would implement its authority over event contracts; and 4) the implications for regulation depending upon the type of market participant.

CWM is a financial services company that is actively involved in bringing the benefits of innovative contracts to market participants. Specifically, CWM is engaged in the research and development of new and innovative derivatives contracts. CWM is currently working with designated contract markets on the design and development of several such innovative contracts. The underlying interests of certain of these contracts are not dependent on market prices or explicit measures of economic or commercial activity. These contracts do, however, track contingencies and risks that have economic consequence for various sectors of business activity.

CWM commends the Commission on its consideration of this important policy issue and is pleased to share its views on the issues raised by the Concept Release.

*Importance of innovation*

CWM believes that first and foremost, the Commission in framing its consideration of these issues should be guided by the emphasis that Congress has placed on protecting innovation in the regulation of futures markets.

Congress' intent that the regulation of futures markets by the Commission support market innovation is a recurring theme throughout the Commission's history. The Congressional mandate to the Commission to promote innovation was an important factor in the Commission's creation. For example, in 1974, Congress was aware that non-traditional futures contracts, such as possible futures contracts on mortgages and ocean-freight rates, were being developed.<sup>1</sup> Congress did not seek to block the growth of innovative futures trading. Rather it expanded the definition of "commodity" from the enumerated agricultural commodities to "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in," intending that such innovative contracts would come within the regulatory purview of the new Commission.

Congress reaffirmed its support of market innovation in the Futures Trading Practices Act of 1992 (the "1992 Act") by granting the Commission broad authority to exempt any agreement, contract or transaction from any of the provisions of the Commodity Exchange Act, 7 U.S.C. §1 *et seq.* ("Act"). Specifically, the 1992 Act added Section 4(c)(1) to the Act, which provides the Commission with broad exemptive authority, "in order to promote responsible economic or financial innovation and fair competition."<sup>2</sup>

Congress' intent that the regulatory framework bolster market innovation was clearly expressed in the ground-breaking Commodity Futures Modernization Act of 2000 (CFMA). The CFMA fundamentally altered the regulation of futures trading in the U.S. by replacing prescriptive, one-size fits all regulation with tiered, principles-based regulation of markets and clearinghouses. The fundamental building block of the CFMA's architecture is choice—a market is permitted to choose a lower tier of regulation by limiting the nature of the contracts and participants that it admits for trading. Of equal importance is the fact that nothing prohibits a market from opting for a

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<sup>1</sup> See e.g. H.R. Rep. No. 975, 93<sup>rd</sup> Cong. 2d Sess. 76 (1974).

<sup>2</sup> Section 4(c)(1) of the Act provides that the Commission may exempt any contract, agreement or transaction from any of the provisions of the Act if the exemption is consistent with the public interest. The Conference Report to the 1992 Act stated that the public interest should include the national public interests of the Act, the prevention of fraud and preserving the financial integrity of the markets, *in addition to promotion of responsible economic or financial innovation* and fair competition. House Conference Report No. 102-978, p.78.

higher regulatory tier than that which would otherwise apply.<sup>3</sup> Since its enactment, the CFMA has become a benchmark for regulatory reform efforts.<sup>4</sup> One of Congress' primary purposes in enacting the CFMA was to "to promote innovation for futures and derivatives."<sup>5</sup>

The Commission has heeded the Congressional directives to foster market innovation, paving the way for many market advances. Under the Commission's administration of the Act, financial futures were introduced and exchange-traded options were re-introduced. The introduction of financial futures included the groundbreaking introduction of cash-settled futures contracts. Cash settlement for the first time made possible the trading of futures contracts on intangible "commodities"—that is, contracts that are not capable of being delivered. Included within this category are various formulas or mathematical constructs; these may relate to the price level of various indexes, including equity indexes, or they may be for contracts on an underlying that is not related to price levels or broad measures of commercial activity, such as contracts on weather and climate conditions, crop yields, bankruptcy filings and events such as the possible merger of two companies. Most of these innovations have gained widespread acceptance and are now commonplace tools of the market. It is easy to forget that when introduced, each of these instruments was revolutionary and skeptics often questioned whether the innovative trading instrument was subject to the Act and to the Commission's regulatory jurisdiction. For example, prior to their approval by the Commission, some argued that cash-settled contracts could not possibly fall within the definition of "contracts for future delivery" under the Act.<sup>6</sup> Similar doubts were raised with respect to weather futures, crop yield contracts credit default event futures contracts and others. In each of these instances, the Commission, to its credit, has leaned toward fostering market innovation.

#### *Products Eligible for Trading on Contract Markets*

Based upon its past history of fostering innovation in market products, and the intent and structure of the Act as amended by the CFMA, the Commission should affirm a policy of permitting the broadest range of futures and option contracts to be traded on designated contract markets permitted under the Act. In this regard, the Commission in

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<sup>3</sup> See, "A New Regulatory Framework, Report of the Commodity Futures Trading Commission Staff Task Force," (February 2000) ("Staff Report"). The CFMA grew out of the Commission's regulatory reform recommendations. The Staff Report noted on page 3 that, "the task force suggests that the Commission's regulatory framework . . . to the degree possible . . . rely on voluntary submission to Commission oversight." Thus, even if a market limits the contracts traded thereon to contracts in excluded commodities and its participants to eligible contract participants, it would not be prohibited from opting to subject itself to the full panoply of regulation and applying for designation as a contract market.

<sup>4</sup> See "The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure" (March 2008) at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>, pp. 11-12.

<sup>5</sup> Section 2(6) of the Commodity Futures Modernization Act of 2000, Pub. Law No.106-554, 114 Stat. 2763.

<sup>6</sup> See Paul M Architzel and John P. Connolly, "Delivery on Futures Contracts as A Legal Requirement," 36 Bus. Law. 935 (1981).

the Concept Release looks to former section 5(g) of the Act for guidance with respect to which contracts may be listed for trading by a contract market. Concept Release at 25672. However, as the Commission notes, this provision was repealed by Congress in 2000. Congress, through its enactment of the CFMA, rejected the prior requirement that a contract market must demonstrate that a proposed futures contract satisfies the economic purpose test that was embedded in the public interest test of former section 5(g). For the Commission to resurrect this requirement would be an unwarranted backwards step and contrary to the intent of Congress. Accordingly, the Commission should look primarily to the Act as amended by the CFMA for guidance with respect to defining the scope of “commodity” within the meaning of the Act.

As the Commission notes, the term “excluded commodity,” which was added by the CFMA in 2000, is defined in section 1a(25). “Excluded commodities” are a subset of “commodity” and therefore logically must fall within the meaning of “commodity” under the Act. “Excluded commodities” include “any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract. . .,” or “an occurrence, extent of an occurrence, or contingency . . . that is (I) beyond the control of the parties to the relevant contract . . . and (II) associated with a financial, commercial, or economic consequence.” Section 1a(13)(iii) and (iv) of the Act.

In formulating the definition of “excluded commodity,” Congress steered clear of the language of the economic purpose test of former section 5(g). Congress, at the time it enacted the CFMA,<sup>7</sup> was aware that the economic purpose test was incorporated by the Commission in Guideline No. 1 of the Commission’s rules and chose nonetheless to repeal section 5(g) of the Act. Congress at that time chose to use different wording from the old economic purpose test in the definition of “excluded commodity”—an occurrence or contingency “associated with a financial, commercial or economic consequence.” The Commission has offered a gloss on this language in the Concept Release, noting that contracts previously listed by exchanges “have[] generally-accepted and predictable financial, commercial or economic consequences.” Concept Release at 25671. This formulation, however, grafts additional concepts onto the language of the Act that may raise the bar higher than where Congress placed it.

The Act’s language does not require that excluded commodities based on an occurrence or a contingency have a *generally accepted* and *predictable* financial, commercial or economic consequence. The Commission’s formulation may lead to imposing a requirement that the designated contract market demonstrate, prior to listing an innovative product, that the proposed new contract already enjoys market acceptance or that it enjoys a stable, ‘predictable,’ basis relationship with the underlying commodity. It is unlikely that contract markets, when first proposing weather contracts, could have demonstrated that their utility was generally accepted or whether they would exhibit a

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<sup>7</sup> Guideline No. 1 has been retained by the Commission as part of its acceptable practices following enactment of the CFMA and is now found as Appendix A to Part 40. The economic purpose test is contained in 17 C.F.R. Part 40, Appendix A, §(a)(4).

predictable basis relationship to the underlying. Both of these issues may not be susceptible to proof prior to a contract's listing for trading. These issues are better left to the market to decide, based upon trading and market experience, as Congress intended through the 2000 amendments to the Act.

Accordingly, the Commission, in any subsequent action that it takes with respect to event contracts, should make clear that a designated contract market may self-certify (or be approved by the Commission to list a contract if it so requests)<sup>8</sup> a futures or option contract on an underlying interest that meets the definition of excluded commodity. As the Commission noted, "excluded" commodities are a subset of "commodity" as defined by the Act, and thus the Commission would be establishing a safe-harbor, rather than delineating its jurisdictional boundaries. This safe-harbor approach also could be extended by the Commission, as appropriate, to additional services, rights or interests that may not satisfy the definition of "excluded commodity," but which are appropriately classified as commodity futures or options. By taking this approach, the Commission would ensure that it does not impede innovation of new products that Congress has defined as being within the scope of the Act, while leaving open the possibility of addressing particular commodities that are not included within the broad safe-harbor, as examples arise.

A safe harbor approach is also useful because it can be used to identify instruments that clearly are outside of the Act's jurisdiction. In this regard, the Commission, in its Concept Release, has raised the issue of how it could distinguish event contracts that are within the Act's broad definition of "commodity" from gaming contracts. Concept Release at 25673. Gaming contracts might be thought of as contracts that are dependent upon the outcome of discrete events that are not associated with a financial, commercial or economic consequence, but rather have utility only for their entertainment value. Thus, a contract that is contingent upon the outcome of a specific sporting event is unlikely to be associated with a financial, commercial or economic consequence and its primary or sole utility to the parties entering into the contract is its entertainment value. The staff, in designating HedgeStreet as a contract market, implicitly adopted this line of reasoning by accepting HedgeStreet's undertaking not to list binary event contracts on the outcome of sporting events. In so doing, staff noted that such contracts lacked a "legitimate economic purpose."<sup>9</sup> The Commission could also find guidance in various Federal statutory definitions of "gaming" or "wagering."<sup>10</sup>

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<sup>8</sup> 17 C.F.R. §40.3 establishes a procedure for the voluntary submission of new products by contract markets for Commission review and approval.

<sup>9</sup> "Designation Memorandum of Hedgestreet, Inc.," from the Division of Market Oversight to the Commodity Futures Trading Commission, dated, February 10, 2004, [http://www.cftc.gov/files/opa/press04/opahedgestreetdesignationmemo\\_web.pdf](http://www.cftc.gov/files/opa/press04/opahedgestreetdesignationmemo_web.pdf), footnote 3.

<sup>10</sup> For example, as discussed *infra*, the Unlawful Internet Gambling Enforcement Act of 2006 includes a definition of wagering or betting. *See also*, footnote 11.

In offering a definition of gaming contracts which are outside of its jurisdiction (and thus may not be listed for trading by a designated contract market), the Commission should take care to distinguish event contracts on the outcomes of discrete sporting events<sup>11</sup> from contracts on an underlying sports-related service, right or interest that is associated with a financial, commercial or economic activity and that is not dependent on the outcome of a specific sporting contest. There are many types of contracts which may be developed that could be associated with the financial, commercial or economic aspects of the business operations of sports enterprises. As any other business, sports businesses generate significant revenue streams from ticket sales, sales of licensed merchandize and other sources. In this regard, various commercial enterprises may have hedgeable risks or require a means to manage or shift risks that relate to the financial, commercial or economic consequences associated with operation of a sports-related business or sports organization. Contracts addressing these business needs would serve *bona fide* business purposes, would fall within the Congressional definition of "excluded commodity," and would even likely meet the former economic purpose test as being able to be used for hedging or price basing purposes on more than an occasional basis. The Commission should take care in any guidance or rules that it proposes to distinguish this type of *bona fide* contract from contracts that might constitute gaming contracts.

Accordingly, CWM believes that the Commission should make clear in any guidance or rules that the Commission proposes that a designated contract market may list for trading any futures or option contract, including binary option contracts, as long as the contract falls within the broad meaning of "commodity" under the Act. This would include any underlying service, right or interest that meets the plain language meaning of the Act's definition of "excluded commodity" and would include, among others, any underlying that is an occurrence beyond the control of the parties to the relevant contract and associated with a financial, commercial or economic consequence, or any index based on rates, values or levels that are not within the control of the parties to the contract. CWM further believes that it is important that the Commission, in distinguishing contracts that fall within the Act from gaming contracts, recognize the distinction between contracts on discrete sports-related events or outcomes which are commonly included in definitions of "gaming" from contracts for services, rights or interests that are associated with the financial, commercial or economic consequences of operating a sports-related business. Such sports-related contracts, which are not dependent upon the discrete outcome of a sporting event or contest, clearly would meet the criteria for regulation under the Act.

With these general comments in mind, CWM is pleased to address the specific questions raised by the Commission. As appropriate, CWM has grouped together various questions for response.

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<sup>11</sup> Sporting contests or events are typically included in definitions of "gambling" or "wager." 18 U.S.C. §1955 and 26 U.S.C. § 4421 also define "gambling" or "wager."

*Public Interest*

*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?*

*2. How are these interests consistent with the public interest goals embodied in the Act?*

CWM develops contracts that are associated with a financial, commercial or economic consequence to be listed for trading on designated contract markets. The Commission has noted that contracts that “generate trading prices that predictably correlate with market prices or broad-based measures of economic or commercial activity. . . are unambiguously subject to CFTC regulation.” Concept Release at 25669 note 2. CWM agrees with the Commission’s conclusion, but notes that correlation with “broad-based measures of economic or commercial activity” may be too narrow a formulation for defining those contracts that clearly fall within the scope of the Act. For example, there are many potential examples of contracts that generate trading prices associated with a financial, commercial or economic consequence that may not measure broad sectors of the economy. These contracts nevertheless may fulfill the same functions, but for more discrete economic activities. The public interest served by such contracts is exactly the same as those served by contracts that are broad-based measures of economic activity. They provide a means of risk shifting and, through the discovery of prices traded on the market, information that can be used in the allocation of economic resources.

Contracts that are traded purely for information aggregation purposes, so long as their trading is associated with a financial, commercial or economic consequence, are likely to serve the same public interest as traditional futures contracts, albeit in a less linear fashion. Among the Commission’s examples of event contracts is “accomplishment of certain scientific advances.” A contract on development of a certain type of long-lasting battery, for example, would be useful for both risk shifting and price discovery purposes. Certainly, those engaged in funding such research might make use of such a contract to transfer some of the risk associated with unforeseen development delays.

Moreover, the trading prices discovered in the market would provide important information to the markets generally, which could be used in efficiently allocating resources. The discovery of market prices in a traditional futures contract can be used in exactly this way—higher prices signaled by futures trading may be used as a signal by economic actors in the allocation of resources. For example, a producer seeing a high futures price for a commodity might decide to increase production in that commodity. Similarly, pricing signals from a contract on the introduction of a new battery might

cause a manufacturer to invest greater resources in research and development, to make the changes necessary to manufacture a new generation of batteries, or to forego new investment in the existing technology.

Such use of prices generated from trading fits within the Section 3 findings that transactions subject to the Act are affected with a national public interest by providing a means of “disseminating pricing information.” Note that section 3 distinguishes between “discovering *prices* or disseminating pricing *information*.” Thus, section 3 distinguishes between the discovery of prices themselves and making publicly available pricing information. By using different words, it is reasonable to infer that Congress intended to include within this provision different concepts. It is also reasonable to infer that “price basing” is intended to relate directly to the price of the commodity and “disseminating pricing information” is intended to include a broader concept than mere “price basing.” In this way, a non-price-related underlying, when traded on a contract market may nevertheless result in the dissemination of pricing information. For example, a crop yield contract may not be usable for discovery of the price of a commodity, but it may provide pricing information that can be used in resource allocation. This is similar to the benefits available from trading in a scientific or other event contract.

*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?*

A designated contract market should be able to list any futures or option contract on a commodity with no further calculation or analyses. Congress, in repealing section 5(g) and in removing the requirement that contract market designation be on a contract-by-contract basis, intended that designated contract markets no longer be required to justify that trading in a particular contract meets a specific statutory test (other than meeting the applicable Core Principles of the Act) prior to its self-certification by the contract market. Where a contract on an occurrence is associated with a financial, commercial or economic consequence, the contract would clearly be a commodity and should be able to be listed through exchange self-certification or through voluntary approval with no special demonstration or analyses. There should not be separate tests requiring contracts based on an occurrence to prove the value of the pricing information disseminated by the market. Rather, it can reasonably be inferred that an event contract that is associated with a financial, commercial or economic consequence will also fulfill the public interest goals of the Act with respect to the dissemination of pricing information.

As discussed above, Section 5(g) of the Act, the statutory provision underlying the Commission’s previous requirement that a designated contract market demonstrate that a commodity futures or option contract that it proposes to list for trading fulfill a hedging or price basing function on more than an occasional basis, was repealed in 2000.