

Received CFTC
Records Section

9/8/08

08-4
29

September 2, 2008

VIA E-MAIL

COMMENT

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

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

Dear Mr. Stawick:

The Coalition for Internal Markets appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") Concept Release on the Appropriate Regulatory Treatment of Event Contracts, 73 *Fed. Reg.* 25669 (May 7, 2008) ("Concept Release"). The Concept Release notes that the Commission is soliciting comment "on the appropriate regulatory treatment of financial agreements offered by markets commonly referred to as event, prediction, or information markets." The Commission defines event markets for the purpose of the Concept Release as contracts that "are neither dependent on, nor do they necessarily relate to, market prices or broad-based measures of economic or commercial activity."¹

The Coalition for Internal Markets ("CIM") is a coalition of public companies that sponsor event markets that are open for participation only by their employees or similar individuals. The Coalition presently is composed of Google, Inc. and Yahoo! Inc. Although the details differ with respect to how our internal event markets operate, we share a common belief in the use of internal markets as an accurate means of information aggregation, including pricing information, in the economic utility of such markets and in the benefits that they provide the public even when used as an internal forecasting and prediction tool. In light of our experience with the benefits of these markets, as discussed in greater detail below, we also support the availability of similar "public" markets. We believe that our experiences as operators of internal markets will provide the Commission with additional facts and insights with respect to the use of internal event markets by companies in the operation of their businesses.

How our markets operate

¹ Concept Release, 73 *Fed. Reg.* at 25669.

Google

Google has operated a prediction market since April, 2005. Its operation is patterned after that of the Iowa Electronic Markets, except that currently no money is used by its market participants. In Google's terminology, each question that is the subject of trading activity is termed to be a "market." Questions are not binary in nature, but the 2 to 5 possible responses are mutually exclusive.

Payment for correctly predicting an event is one unit of a fantasy currency. There is no pay-out for incorrect predictions. Traders wishing to participate in the market are given a supply of currency at the beginning of each calendar quarter. Trading is conducted via a continuous double auction in each market. Participation is limited to current employees and some contractors and vendors. There is no automated market maker, but several employees did create robotic traders that sometimes played this role.

The market itself originates all contracts in the form of a long and short bundled position. Traders can purchase from the market a bundled long and short position for a single unit of currency and then decompose the bundle and sell any of the contracts in their purchased bundle. Traders are not, however, permitted to create short positions. Traders may also purchase a position from another trader that has purchased a bundled position from the market. Traders can also reassemble the contract bundles and sell them back to the market. Currency units at the end of each quarter can be redeemed for raffle tickets for a variety of modest prizes.

Since its inception, the Google market has traded 25 to 30 separate "markets" each calendar quarter. The markets were designed so that each expired by the end of the quarter in which it was listed. New markets were then listed with the beginning of a new quarter.

The markets listed on Google's internal prediction market relate to forecasts of product demand; to internal performance, such as whether a new product will leave beta on time; on company news unrelated to direct performance, such as whether the company will open a new office in a specified location; and to the external business environment that might affect planning decisions, such as the mix of hardware and software used to access Google. In addition, Google hosted a few markets unrelated or marginally related to Google's business which were included for training purposes.

Google has used its internal marketplace not only to make forecasts, but also to monitor and evaluate how information and attitudes are distributed within its organization. For example, Google has also used its internal market data to assess the strength of relationships between various working teams. Google has also used its prediction market data to measure how optimism about its business objectives varies over time and in different parts of its organization.

Yahoo!

Yahoo! Inc. has been designing, building, and analyzing prediction markets since 2002. Since that time, Yahoo! has experimented with internal markets to identify promising new products and to guide strategic decision-making within the company. Yahoo!'s internal markets are open only to company employees or similar persons. Yahoo!'s internal markets operate using an automated market maker. Some use Hanson's logarithmic market scoring rule market maker and others use Yahoo!'s own dynamic parimutuel market maker.

In addition to its internal markets, Yahoo! has fielded three prediction market experiments open to the public: the Yahoo!-O'Reilly Tech Buzz Game, the Bix American Idol market, and the Yoopick sports prediction market. Each of these publicly offered prediction markets is operated as a game, using virtual currency. Those wishing to participate are provided with virtual dollars to fund their trading account. The opening round of the Tech Buzz Game awarded modest prizes to the top traders. In subsequent rounds of the Tech Buzz Game and the other Yahoo! public markets, no prizes are awarded; rather the incentive is the reward of doing well compared to other traders.

For example, the Yahoo!-O'Reilly Tech Buzz Game enables players to buy contracts in technologies that they consider to be popular and to sell those that they believe to lack merit. Contracts are listed in various, rival technologies. Players have access to the current "buzz" around each technology, as measured by the number of Yahoo! Search users seeking information on it. The fantasy market's object is to anticipate future search buzz and to buy and sell contracts accordingly. Thus, a player who believes one type of technology is undervalued might buy contracts in that technology, while a player who thinks that the technology is overpriced might sell its contracts, or buy a competing technology. The Tech Buzz game employs the dynamic parimutuel market design invented at Yahoo!, thus serving as a testbed for understanding and evaluating this new technology. See <http://research.yahoo.com/node/207>.

The goals of Yahoo!'s public experiments are two-fold: to produce useful data about consumer trends and to evaluate alternative market designs for their efficacy. Having better data about consumer trends and search volumes helps Yahoo! improve the quality of its search engine, which is important to improving the public's ability to access information readily, and the relevance of its advertisements, from which Yahoo! derives billions of dollars in revenue annually. It also helps its product developers and others better anticipate future areas of consumer demand.

Yahoo! also uses prediction markets by incorporating them into its content pages. For example, Yahoo! News highlights prediction market odds on its popular Election Dashboard product, which is viewed by tens of millions of people. See <http://news.yahoo.com/election/2008/dashboard>.

As part of its research into internal prediction markets, scientists within Yahoo! Research have published a dozen academic papers including data analyses of existing markets and designs for next-generation markets, filed half a dozen patent applications, and organized four workshops on the topic.

Future Evolution

CIM believes that the performance of the experimental prediction markets described above would be enhanced if traders were able to commit funds to their trading positions, even if the potential stakes are limited. CIM further believes that this step is necessary for these markets to reach their potential with the associated benefits to the public. This evolution can and should be fostered by the Commission under its Congressional mandate to foster innovation in the futures markets.

Statutory and Regulatory Background Encourages Innovation

Congress has encouraged the Commission to administer the Commodity Exchange Act, 7 U.S.C. 1 *et seq.* (“Act”) in a flexible manner, furthering market innovation to the greatest degree possible. Indeed, in enacting legislation to comprehensively regulate commodity futures trading in 1974, Congress was aware that non-traditional futures contracts, such as possible futures contracts on mortgages and ocean-freight rates, were being developed.² It is clear that the broad definition of “commodity” under the Act, which is in contrast to the prior practice of Congress of enumerating those “commodities” which were subject to the Act, underscored Congress’ intent that the Act be sufficiently broad to apply to new and innovative futures contracts as they are developed.³

Equally important, in 1992 Congress added Section 4(c)(1) to the Act, granting the Commission broad authority to exempt any agreement, contract or transaction from any of the provisions of the Act.⁴ Congress added this broad exemptive authority “in

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

³ In the absence of such a broad application of the meaning of “commodity” it might be possible to return to the situation prior to the 1974 amendment wherein futures trading in some contracts was unregulated by the Commodity Exchange Authority, the Commission’s predecessor agency, because the contract’s underlying was not within the definition of “commodity.” Prior to the Commodity Futures Trading Commission Act of 1974, the “commodities” covered by the Act were specifically enumerated. Thus, in order for the Commodity Exchange Act to apply to a new contract, Congress was required to amend the Act and enumerate the new “commodity.” This meant that some futures contracts were regulated under the Act and others were not. By adopting such a broad and flexible definition of “commodity” Congress clearly intended that all futures contracts that could trade on an exchange would be regulated under the Act as such.

⁴ See Section 203 of the Futures Trading Practices Act of 1992 (the “1992 Act”)

order to promote responsible economic or financial innovation and fair competition.”⁵ As the Commission notes, “under Section 4(c), the Commission has the discretion to grant an exemption to certain classes of transactions without having to make a determination that such transactions are subject to the Act in the first instance.” Concept Release, 73 *Fed. Reg.* at 25672. The Commission further notes that it may use its exemptive authority “to establish a set of regulatory provisions applicable to a defined class of products.” *Id.* at 25673.

Congress, through its enactment of the Commodity Futures Modernization Act of 2000 (“CFMA”), again reaffirmed its intent that the Commission administer the Act flexibly and to further market innovation. A primary purpose of the CFMA was “to promote innovation for futures and derivatives.”⁶ The CFMA does so by replacing prescriptive, one-size fits all regulation with a system of principles-based regulation. The overarching principle of the CFMA is that the level and degree of regulation will vary depending upon the type of market participant and the nature of the commodities traded. Based upon this principle, the CFMA establishes a system of tiered regulation wherein the degree and nature of regulation varies depending upon the nature of the market regulated. Thus, some market tiers are subject to fewer or different regulation depending upon the nature of the market participants and the commodities traded.

The Commission throughout its history has responded affirmatively to the Congressional mandate to foster innovation in futures trading and in futures markets. The Commission re-introduced exchange-traded options, initially through a very successful pilot program.⁷ It fundamentally altered the concept of what constitutes a futures contract by approving the introduction of financial futures, including approving the first contracts on broad-based indexes of securities. Even more significant, the Commission approved the first cash-settled futures contract, making it possible to construct and trade futures contracts on any intangible interest which is otherwise incapable of being delivered. Through this action, it has become possible to construct and trade futures contracts on various formulae or mathematical constructs, including indexes or other underlying interests that may not be related to price levels, such as contracts on weather and climate conditions, crop yields, bankruptcy filings, credit default events and events such as the possible merger of two companies. At the time of the introduction of these innovative contracts, doubts were raised with respect to whether such contracts could be considered to be contracts for future delivery of a commodity

⁵ 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.

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

⁷ See 46 *Fed. Reg.* 54500 (Nov. 3, 1981).

within the meaning of the Act. Nevertheless, the Commission in each instance chose to facilitate innovation and these innovations are now widely accepted.

Event Markets Fall Within the Act

As the Commission noted in the Concept Release, “the regulatory purview of the Act extends to and includes transactions that are either structured as options or futures when such transactions involve interests that constitute commodities under the Act.” Concept Release at 2561. As the Commission further notes, “A significant number of event contracts are structured as all-or-nothing binary transactions commonly described as binary options.” Concept Release at 25670. The Commission also points out that event contracts can also price consensus estimates of moving values, the same as any commodity futures contract. The internal prediction markets operated by the Coalition members currently list binary options on the occurrence or non-occurrence of a discrete event or of a number of mutually exclusive alternatives.⁸ Accordingly, the primary issue with respect to whether and how these markets should be regulated by the Commission is whether the underlying subject of the contracts are “commodities” within the meaning of the Commodity Exchange Act, 7 U.S.C. §1 *et seq* (“Act”).

Congress has defined “commodity” under the Act in very broad terms. Prior to creation of the Commission, the Act covered only those underlying interests that were enumerated in the Act. The Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, extended the definition of “commodity” to include “all services, rights and interests in which contracts for future delivery are presently or in the future dealt in.” Section 1a(4) of the Act. Congress, in 1974 was aware that non-traditional futures contracts were being developed such as possible futures contracts on mortgages and ocean-freight rates, and intended to include within the regulatory scheme governing futures trading “all commodities, goods, articles, services, rights, and interests which are or may be the subject of futures contracts.”⁹

The definition of “excluded commodity” under section 1a(13) of the Act provides additional clarity to the meaning of “commodity” under the Act. A commodity that is defined as an “excluded” commodity must, in the first instance, be within the broader definition of “commodity.” Section 1a(13)((iii) and (iv) define an “excluded commodity” as including:

- (iii) 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, agreement, or transaction; or

⁸ Although the more typical contract currently used is a binary contract on a discrete event or several mutually exclusive alternatives, CIM’s members may in the future also list contracts on moving values.

⁹ H.R. Rep. No. 975, 93rd Cong. 2d. Sess. 76 (1974).

(iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is—(I) beyond the control of the parties to the relevant contract, agreement, or transaction; and (II) associated with a financial, commercial, or economic consequence.

Importantly, the section 1a(13)(iii) definition recognizes that the index which is a “commodity” need not be based on price levels, but may also be based on any economic or commercial index on a “rate, value or level” not within the control of the parties to the contract. Similarly, section 1a(13)(iv) leaves open the possibility that the occurrence, extent of occurrence or contingency need not be based on price, but may be on any rate, value or level that is not within the control of the parties to the contract, so long as it is “associated with a financial, commercial or economic consequence.” Accordingly, the very broad definition of “excluded commodity” makes clear that a contract for future delivery of a commodity need not be based on fluctuations in the price level but may be based on any occurrence or contingency relating to any value not within the control of the parties to the contract that is associated with a financial, commercial or economic consequence. Options or futures contracts on weather, climatic conditions, bankruptcies or crop yields all can be described in this manner. So too, can the types of commercially-related events, circumstances or contingencies listed for trading on our internal markets.¹⁰ Thus, it is clear that the Act does apply to certain, if not all, event markets and that clarification by the Commission of its views with respect to the operation of these markets under the Act is an appropriate and necessary step in fostering their development.

CIM's Proposal

CIM believes that the Commission should exercise its section 4(c) exemptive authority and propose rules specifically adapted to, and permitting, the operation of small-stakes event markets. CIM believes that small-stakes event markets of the kind first developed by the Iowa Electronic Markets¹¹ have the potential to provide significant public benefits and recommends that the Commission propose regulations under which such markets may operate, both as internal markets or as public markets. However, CIM strongly believes that the potential benefits of these markets should not be restricted to markets operated by academic or other non-profit entities. The members of CIM are public, for-profit companies that are committed to research and development and to introducing new technologies that improve the communication of knowledge. Accordingly, it is in the public interest and is consistent with the continued leadership of

¹⁰ Our markets also include contracts that are intended merely to maintain trader interest in the market. As we explain in greater detail below, we believe that such contracts should be eligible to be listed on an internal event market pursuant to Commission rules adopted under the Commission's section 4(c) exemptive authority.

¹¹ Concept Release , 73 *Fed. Reg.* at page 2570.

