Kalshi

September 25, 2022

SUBMITTED VIA CFTC PORTAL
Secretary of the Commission
Office of the Secretariat
U.S. Commodity Futures Trading Commission
Three Lafayette Centre 1155 21st Street, N.W.
Washington, D.C. 20581

Re: Comments Responding to the Commission's Specific Questions Related to KalshiEX, LLC's Proposed Congressional Control Contracts

To Whom It May Concern:

KalshiEX, LLC ("Kalshi" or "Exchange") is grateful to the Commission for its consideration of Kalshi's proposed contracts. The Exchange welcomes the opportunity to address the Commission's questions. This comment addresses the first question and the third question that the Commission asked:

1. Do these contracts involve, relate to, or reference gaming as described in Commission regulation 40.11(a)(1) and section 5c(c)(5)(C) of the Commodity Exchange Act, or in the alternative, involve, relate to, or reference an activity that is similar to gaming
2. as described in regulation 40.11(a)(2) or section 5c(c)(5)(C) of the Commodity Exchange Act?
3. Do these contracts involve, relate to, or reference "an activity that is unlawful under any State or Federal law" as described in Commission regulation 40.11(a)(1) and section 5c(c)(5)(C) of the Commodity Exchange Act?

This comment is divided into two parts. Part 1 discusses the statute. In particular, Part 1 of the comment addresses section 5c(c)(5)(C) of the Commodity Exchange Act ("CEA"), codified[1] at 7 U.S.C. 7a-2(c)(5)(C).[2] Of particular importance, Part 1 is based on an analysis of the statute

[1] The CEA section designations do not align with the section designations in the United States Code. Because this is a public comment, the Exchange will generally use citations to the United States Code as opposed to the CEA, which will enhance the public's ability to research and analyze the issues presented.
[2] The Exchange will address the applicability of the regulations at 17 C.F.R. 40.11 in a separate comment, and also in the appendix to this comment in the Counsel Analyses. However, the Exchange notes here that the regulation cannot exceed the authority in the statute that the regulation implements. This is axiomatically true even under the *Chevron* deference from *Chevron, Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). Indeed, step one of *Chevron* is to determine whether Congress expressed intent in the statute and, if so, whether or not the statute's intent is ambiguous. It is black letter law that if the statute is clear, the regulating agency cannot regulate contrary to the statute. Indeed, earlier this year in *Empire Health*, Justice Kagan, writing for the Court, held that the government's regulation was valid only because the "regulation correctly construes the statutory language at issue." *Becerra v. Empire Health Foundation*, 142 S. Ct. 2354 (2022). Had that not been the case, Justice Kagan and the Court would have held the regulation invalid.

irrespective of any rule, including 40.11, which the Commission has issued or may, in the future, promulgate to implement this statutory provision.

As a threshold matter, the Exchange notes that the majority of the Commission's questions for public comment assume that the Special Rule in CEA 5c(c)(5)(C) ("Special Rule") applies or can apply to Kalshi's political control contract ("Contract"), a question that the Commission invites the public to address in questions 1 and 3. If the answers to questions 1 and 3 are no, many of the other questions become moot, at least in regard to the Contract, which is the sole matter under Consideration in this Commission action.[3]

Part 2 includes analyses from Jonathan Marcus and Dan Davis that directly address Questions 1 and 3. Messrs. Marcus and Davis both served as General Counsel of the Commission prior to assuming their current positions in private practice.

Part 1

Contracts, events, and other important terms

There are several terms that are key to understanding the framework that Congress created for the Special Rule that appear throughout this comment and are helpful to define here:

- "Event Contract"
- The "Event Contract's Event" (also, referred to as the "contract's Event")
- The "contract, considered as a whole" (also, referred to as the "contract, as a whole", the "contract, itself", and the "contract itself, considered as a whole")

An "Event Contract" is a contract that is based on an occurrence, extent of an occurrence, or a contingency. For example, a contract whose terms and conditions specify that the holder of the contract will receive payment based on the occurrence of a hurricane is an Event Contract because it is based on an occurrence, a hurricane. The terms and conditions of Kalshi's Contract specify that holders of the contract will receive money based on the occurrence of political control over Congress.[4] It is an event contract because it is based on an occurrence, political control.[5]

A contract's "Event" refers to the specific occurrence, extent of an occurrence, or contingency on which the contract is based. A hurricane contract's event is the hurricane. Kalshi's Contract's event is political control

The phrase "contract, considered as a whole" refers to a broad view of a contract and all factors that surround or are a part of the contract. For example, this would include the activity of buying and selling the contract ie. the activity of *trading* the contract, the information embedded in the contract's pricing, and in the case of an Event Contract, the contract's Event.

Accordingly, any suggestion that the Commission's regulation 40.11, which implements the statute at 7 U.S.C. 7a-2(c)(5)(C), applies to a contract to which the statute itself does not apply is specious. If the regulation did, it would be invalid. Regardless, a careful reading of the regulation shows that the regulation does not apply to any contract to which the statute does not apply. We address the regulation in more depth in Part 2.

[3] Specifically, if the answers to questions 1 and 3 are no, the following questions would be moot insofar as they would not apply to the Contract: 2, 4, 6, 7, 8, 9, 10, 11, 12, 13, 14, 17. Question 5, which assumes the soundness of the legal reasoning in the Nadex Order, *see infra*, would also be moot.

[4] Please see the full filing for the full terms and conditions of the Contract.

[5] Specifically, the contract is based on the party membership of the Speaker of the House and the President Pro Tempore.

The statute

Part 1 of this comment focuses on the correct interpretation of the Special Rule, which is set forth in a statute. The full text of the statute[6] is included here, for the reader's convenience:

> **(C) Special rule for review and approval of event contracts and swaps contracts**
>
> **(i) Event contracts**
>
> In connection with the listing of agreements, contracts, transactions, or swaps in excluded commodities that are based upon the occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or levels of a commodity described in section 1a(2)(i) of this title), by a designated contract market or swap execution facility, the Commission may determine that such agreements, contracts, or transactions are contrary to the public interest if the agreements, contracts, or transactions involve-
>
> (I) activity that is unlawful under any Federal or State law;
> (II) terrorism;
> (III) assassination;
> (IV) war;
> (V) gaming; or
> (VI) other similar activity determined by the Commission, by rule or regulation, to be contrary to the public interest.
>
> **(ii) Prohibition**
>
> No agreement, contract, or transaction determined by the Commission to be contrary to the public interest under clause (i) may be listed or made available for clearing or trading on or through a registered entity.

General background on the CEA's Special Rule

Under the CEA, contract listing is not a "permission" regime. Contracts do not need Commission approval to be listed, and although the CEA provides a mechanism that exchanges may utilize to put a contract before the Commission for approval, whether or not to utilize that method is solely

[6] 7 U.S.C. 7A-2(c)(5)(C).

in an exchange's discretion.[7] Indeed, the overwhelmingly vast majority of contracts are never presented to the Commission for approval under this mechanism. Even in those rare instances when the Commission is formally presented with a contract for approval, the Commission's discretion over whether to grant or withhold approval is limited; under the statute and the regulations, the Commission must approve every contract that does not violate the CEA or the regulations.[8] The Commission was not granted authority to conduct a "is this a contract that I am comfortable with" analysis and the Commission was not granted authority to disapprove a contract because it does not like it.[9]

The Commission was also not granted the authority to prohibit any contract on the grounds that it violates the public interest. There is one exception to this rule, where Congress did give the Commission the authority to prohibit a contract that the Commission determines is contrary to the public interest.[10] This exception is the Special Rule in 5c(c)(5)(C) of the Commodity Exchange Act.[11] This Special Rule gives the Commission discretion to consider, for very specific types of contracts, whether a contract is contrary to the public interest.[12]

There are two aspects to the Special Rule. The first is the Special Rule's eligibility requirements; the Special Rule does not apply to all contracts. It only applies to a specifically defined subset of contracts, identified through a two-step process described below, that are eligible for the Special Rule. If a contract is determined to be eligible for the Special Rule, it is not automatically prohibited. The Special Rule only prohibits contracts that are eligible for the Special Rule al Rule if the Commission determines that the contract is contrary to the public interest. The second aspect of the Special Rule thus is determining whether the contract that is eligible for the Special Rule is contrary to the public interest. Congress laid out the process for the Special Rule in three steps.

<u>The three steps of the Special Rule</u>

There are three steps in the Special Rule.

Step one of the Special Rule ("Step One") is to determine if the contract is eligible for the Special Rule. The statute limits the scope of the Special Rule to contracts that are "based upon [an] occurrence, extent of an occurrence, or contingency" (collectively "Event"). In other words, to be eligible for the Special Rule, a contract must be based on an Event, *i.e.*, the contract must be an Event Contract. If a contract is not an Event Contract, it is not eligible for the Special Rule and the contract fails Step One. The analysis then terminates and the Special Rule does not apply to that contract. If the contract is an Event Contract, the analysis proceeds to step two.

Step two of the Special Rule ("Step Two") is to determine if the Event Contract's Event involves[13] certain activities that were listed by Congress in the Special Rule. These activities are:

1. an activity that is unlawful under any Federal or State law;

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[7] This process is set forth in 17 C.F.R. 40.3, which the Commission titled "*Voluntary* submission of new products for Commission review and approval."
[8] 7 U.S.C. 7a-2(c)(5)(B); 17 C.F.R. 40.3(b).
[9] *Id.*
[10] As explained below and in a second comment letter, even if, *argunedo*, the Special Rule applied to the Contract (which it does not), the Special Rule would still not prohibit the Contract because it is *in* the public interest, and therefore certainly not contrary to the public interest.
[11] 7 U.S.C. 7a-2(c)(5)(C).
[12] *Id.*
[13] Please see *infra* the "A further look at step two of the Special Rule" for more discussion on the correct interpretation of step two and why step two is limited to the contract's Event.

2. terrorism;
3. assassination;
4. war;
5. gaming;

In addition to these five specific activities, Congress included a sixth activity: "other similar activity determined by the Commission, by rule or regulation, to be contrary to the public interest."[14] This sixth activity gives the Commission discretion to identify other similar activities that are contrary to the public interest. If the Event Contract's Event does not involve any of the six activities that are listed in the Special Rule, the Event Contract is not eligible for the Special Rule. The analysis terminates and the Special Rule does not apply to prohibit the contract. If the Event Contract's Event does involve at least one of these activities, the analysis continues to step three.

Step three of the Special Rule ("Step Three") is for the Commission to determine whether the contract itself, considered as a whole, is contrary to the public interest.[15] If the Commission does not determine that the contract is contrary to the public interest, the contract is not prohibited under the Special Rule. If the Commission determines that the contract is contrary to the public interest, the Special Rule applies and the contract is prohibited.[16]

The three steps that the Commission follows in applying the Special Rule are therefore:

Step 1: Is the contract an Event Contract? If no, stop. If yes, continue to step 2.

Step 2: Does the Event Contract's Event involve an activity that was included by Congress in the Special Rule? If no, stop. If yes, continue to step 3.

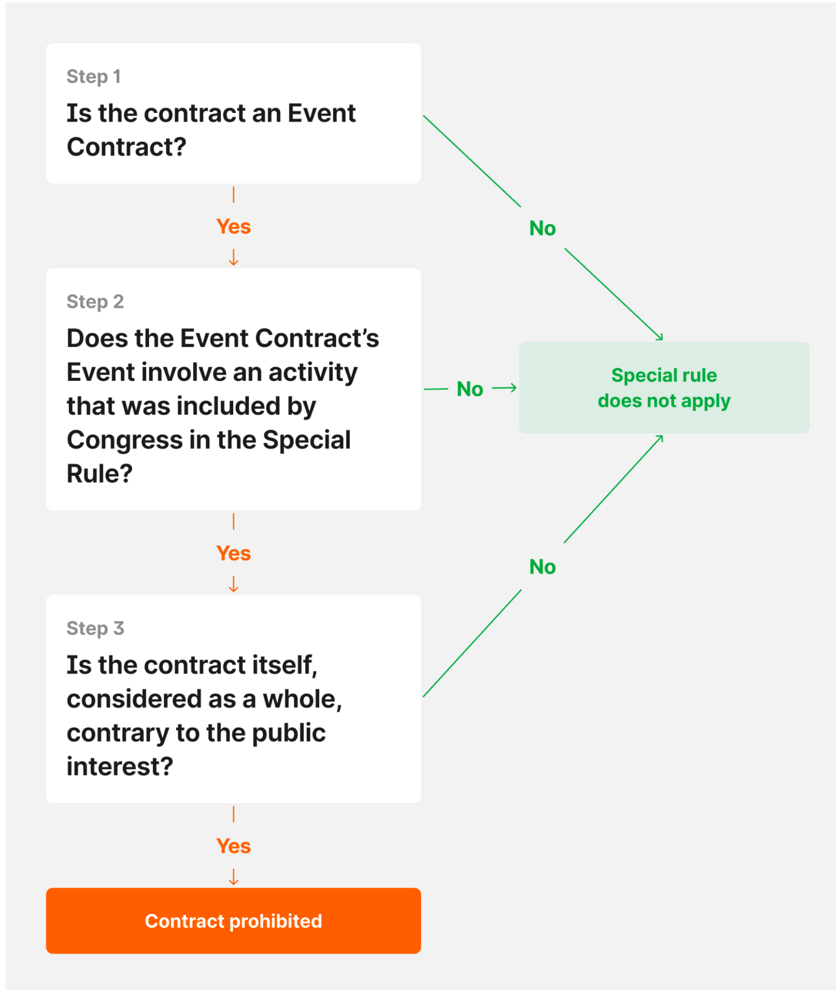
Step 3: Is the contract itself, considered as a whole, contrary to the public interest? If no, the contract is not prohibited. If yes, the contract is prohibited.

Graphically, the flow of the three steps looks like this:

[14] 7 U.S.C. 7a-2(c)(5)(C)(i)(VI).

[15] The phrase "contrary to the public interest" is used three times in the Special Rule. It is used in clause (i) in reference to the sixth activity in the list of activities Congress included in step two of the Special Rule. In this context, it is the *contract's Event* that is contrary to the public interest, not the *contract itself*. It is also used in clause (i) in step three and in the prohibition in clause (ii) in reference to the *contract itself*.

[16] 7 U.S.C. 7a-2(c)(5)(C)(ii). ("No agreement, contract, or transaction determined by the Commission to be contrary to the public interest under clause (i) may be listed or made available for clearing or trading on or through a registered entity.")



Step One and Step Two limit the scope of contracts to which the Special Rule applies. Step One limits the Special Rule only to Event Contracts. Step Two limits this scope further. Step Two provides that the Special Rule does not apply to *all* Event Contracts, but only to those contracts whose Events involve one of the activities Congress listed in the statute. Step Three provides that even a contract that passes Steps One and Two is not prohibited unless the Commission determines that the contract, considered as a whole, is contrary to the public interest. The following graphic illustrates how each step of the Special Rule functions to narrow the scope of the contracts that are prohibited under the Special Rule.

All Contracts

Step 1 **Is the contract an Event Contract?**

Step 2 **Does the Event Contract's Event involve an activity that was included by Congress in the Special Rule?**

Step 3 **Is the contract itself, considered as a whole, contrary to the public interest?**

To further explain the role of Step Three, Congress did not prohibit an Event Contract whose Event involves an activity listed in the Special Rule.. It is possible that an Event Contract's Event involves an activity listed in the Special Rule but the Commission does not determine that the contract, considered as a whole, is contrary to the public interest. That contract would not be prohibited under the Special Rule. For example, an Event Contract on the invasion of Ukraine would satisfy Steps One and Two because it is an Event Contract (Step One) and the Event Contract's Event involves war, one of the activities that is listed in the Special Rule (Step Two). That does not mean that the contract is prohibited; it moves to step three for the Commission to determine if the Event Contract, considered as a whole, is contrary to the public interest. The Commission may determine that it is contrary to the public interest, in which case the Event Contract would be prohibited by the Special Rule.[17] And the Commission may determine that it is not contrary to the public interest. As Commissioner Johnson recently noted, "Geopolitical events in Europe, specifically, the invasion of Ukraine has led to remarkable disruptions in energy and agriculture markets."[18] Accordingly, the Commission may find that the Event Contract has hedging utility and/or other economic utility or benefits and thus could not determine that the Event Contract is contrary to the public interest. This point, that a contract's event can involve an activity listed in the statute and still be allowed because the contract itself is not contrary to the public interest was made by then-Commissioner Berkovitz in his statement on ErisX's RSBIX contracts.[19]

[17] 7 U.S.C. 7a-2(c)(5)(C)(ii).

[18] Opening Statement of Commissioner Kristin N. Johnson before the Energy and Environmental Markets Advisory Committee | CFTC, September 20, 2022.

[19] Commissioner Berkovitz's statement is available here: https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement040721. Commissioner Berkovitz concluded his statement by noting that, "If sporting event contracts with an economic purpose, such as hedging, are allowed to be traded on a DCM, the general public must be able to access and trade those contracts on the exchange. The public cannot be barred from trading a contract listed on a DCM. However, gaming contracts without any economic purpose should not be permitted on a DCM."

A further look at step two of the Special Rule

Once an Event Contract passes Step One, the analysis moves to Step Two of the Special Rule. Step Two is to determine if the Event Contract involves an activity that was listed by Congress in the Special Rule. For the purposes of step two of the Special Rule, an Event Contract only involves an activity if the Event Contract's *Event* involves that activity.[20] For example, an Event Contract can only involve war if the Event Contract's Event involves war. Conversely, if the Event Contract's Event does not involve war, then the Event Contract does not involve war. Similarly, an Event Contract will involve gaming only if the Event Contract's Event involves gaming. For the purposes of Step Two, it is irrelevant if something else surrounding the Event Contract, such as the market activity of trading the contract, involves a listed activity. The only relevant factor for Step Two is whether the Event Contract's Event involves the listed activity, not whether the Event Contract, considered as a whole, involves the listed activity.

There are many reasons why the analysis of whether an Event Contract involves a listed activity in Step Two is limited to the Event Contract's Event, and does not include the consideration of the Event Contract as a whole. Many of these reasons are stated in the letters in Part 2 of this comment, as well as by other commenters.[21] The Exchange provides two reasons here. (For convenience, this comment refers to the incorrect reading that the analysis under Step Two includes the Event Contract, considered as a whole, and is not limited to only the Event Contract's Event, as the "Contract as a Whole view of Step Two".)

The Contract as a Whole view of Step Two is wrong. An Event Contract cannot be considered to involve a listed activity based on the Event Contract considered as a whole, and not only the Event Contract's Event. If step two were so broad, it would (1) defeat Congress' intended narrowing function, and (2) render the statute internally inconsistent.

The sixth activity illustrates the flaw in applying Step Two broadly, ie. Contract as a whole View of Step Two. Congress included as the sixth activity a "similar activity [to the first five activities, that is] determined by the Commission, by rule or regulation, to be contrary to the public interest." Under the Contract as a Whole view of Step Two, the sixth activity means that the Commission can determine that any factor that is part of an Event Contract is contrary to the public interest.[22] For example, the Commission can determine that *trading* contracts on a certain event is a "similar activity" to the listed activities and is contrary to the public interest. These contracts would satisfy Step Two even though the Event contracts are based on Events that are *not* contrary to the public interest because the *trading* on the contract *is* contrary to the public interest per the Commission's determination, and trading on the contract is part of the contract when considered as a whole.

The analysis would then move to Step Three. But Step Three calls for a public interest analysis

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[20] The analysis of the Event Contract in Step Three is different from Step Two. The analysis in Step Three considers the Event Contract as a whole, and is not limited to the Event Contract's Event. Conversely, the analysis in Step Two is limited to what activities the Event Contract's Event involves.

[21] *See e.g.* the comments of Josh Sterling, Timothy McDermott, Daniel Gorfine, Lewis Cohen, Jeremy Weinstein, and Railbird Technologies.

[22] This is because under the Contract as a Whole view of Step Two, Step Two is not limited only to looking at the Event Contract's Event. The analysis in Step Two looks at the Event Contract as a whole. Accordingly, the activities included in the list in Step Two are not confined to the Event Contracts' Events, and can include anything related to the Event Contract.

of the Event Contract, considered as a whole, where it has already been determined under Step Two that the *trading itself* is contrary to the public interest, i.e. that the Event Contract, considered as a whole, is contrary to the public interest. This results in two consecutive steps that do the exact same thing:

- Step Two: the Commission determines that the Event Contract, considered as a whole, is contrary to the public interest
- Step Three: the Commission determines that the Event Contract, considered as a whole, is contrary to the public interest (*again*)

This illustrates the fundamental flaw in the Contract as a Whole view of Step Two. What Congress clearly designed is a statute that allows the Commission to apply special scrutiny to contracts based on particular events that Congress identified as problematic. Congress did not shut the door to such contracts, but recognized that trading on an Event Contract whose Event is a problematic activity that involves, say, assassination or terrorism might neverthless have redeeming features (such as hedging utility) that would justify the conclusion that the Event Contract, considered as a whole, is not contrary to the public interest. In this way, Congress clearly differentiated the Event Contract's Event (which may be disfavored), and trading in the Event Contract (permitted where trading on the disfavored activity offers economic and other societal benefits). When trading in the Event Contract *itself* is included in the analysis at Step Two, the distinction Congress sought to draw between the underlying event and trading in the contract is obliterated.[23]

[23] This defect in the statute that emerges from the Contract as a Whole view of Step Two is from the sixth activity. The fact that the defect stems from the sixth activity does not mean that defect is limited to the sixth activity and that the Contract as a Whole View of Step Two is fine with regard to activities one through five. That would misapprehend the way that statutes work. Once it is demonstrated that step two cannot be about the contract, considered as a whole, for even one activity, that view is proven wrong. Therefore, the Contract as a Whole view of Step Two is an incorrect reading of the statute regardless of the activity.

The use of (c)(5)(C)(i)(VI) under the incorrect Contract as a Whole view of Step 2

Step 2
The Commission determines that the **Event Contract, considered as a whole,** is contrary to the public interest

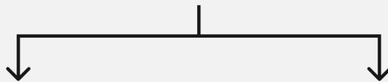
Step 3
The Commission determines that the **Event Contract, considered as a whole,** is contrary to the public interest

Redundant

Contract prohibited

The use of (c)(5)(C)(i)(VI) under the correct view of Step 2

Step 2
The Commission determines that the **Event Contract's Event** is contrary to the public interest



Step 3
The Commission determines that the **Event Contract, considered as a whole,** is contrary to the public interest

Step 3
The Commission determines that the **Event Contract, considered as a whole,** is not contrary to the public interest
(hedging, economic purpose, forecasting value, etc)

Contract Prohibited

Contract Not Prohibited

Additionally, the Contract as a Whole view of Step Two actually renders all of the first five activities in Step Two superfluous. Once a contract passes Step Two, no matter which activity the contract involves, it must pass Step three to be prohibited by the Special Rule. The analysis in Step Three is for the Commission to determine whether the Event Contract, considered as a whole, is contrary to the public interest. *Any* Event Contract that the Commission determines is contrary to the public interest in step three *necessarily* would also satisfy the sixth activity in Step Two. For example, an Event Contract that involves war will pass Step Two. The analysis of the Event Contract will then move to Step Three, and assume that the Commission finds that the contract is contrary to the public interest. At that point, the Event Contract actually involves *two* of the listed activities: (i) it involves the activity of war, and (ii) it *also* involves an activity that the Commission has determined is contrary to the public interest. It is impossible for an Event Contract to pass Step Three and not involve the sixth activity in Step Two. Accordingly, there is no point in the first five activities listed in Step Two, only the sixth activity. In fact, there would be no point in Step Two at all. As noted, the sixth activity in Step Two and Step Three are identical. Accordingly, if the Contract as a Whole view of Step Two is correct, Congress would have just skipped Step Two altogether. The Special Rule would have been a simple six line statute that said only:

> In connection with the listing of agreements, contracts, transactions, or swaps in excluded commodities that are based upon the occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or levels of a commodity described in section 1a(2)(i) of this title), by a designated contract market or swap execution facility, the Commission may determine that such agreements, contracts, or transactions are contrary to the public interest.

The inevitable collapse of all of the Step Two activities into the sixth activity and the collapse of the sixth activity into Step Three under this expansive interpretation of Step Two shows that the Contract as a Whole view of Step Two is wrong. The correct view of Step Two is that it, like Step One, simply describes what the contract is based on, and the analysis in Step Two is limited to the Event Contract's Event. Accordingly, there is a big difference between Step Two, including the sixth activity, and Step Three. Step Two is focused only on the Event Contract's Event. If an Event Contract passes Step Two because the Event Contract's Event involves any of the listed activities, even the sixth activity, the analysis under Step Two will always be different from the analysis under Step Three. The analysis under Step Two will be whether the Event Contract's Event involves the activity. The analysis under Step Three is very different. Step Three does not only consider the Event Contract's Event alone, it considers the Event Contract, considered as a whole. Thus, all of the anomalies that directly stem from the Contract as a Whole view of Step Two disappear under the view that the analysis in Step Two (like Step One) considers only the Event Contract's Event.

The correct reading of the statute is that the analysis in Step Two, like Step One, is limited to the Event Contract's Event. Steps One and Two work in concert to create the eligibility requirements for the *type* of contract that the Special Rule applies to (*i.e.*, an Event Contract whose Event involves a listed activity), and Step Three serves as an independent step whose analysis considers the Event Contract, as a whole. Together, all three steps form a coherent and cohesive statutory rule that implements Congress's intent to have the Commission review a narrow subset of event contracts whose underlying events involve activities (such as terrorism and assasination) Congress did not want to automatically legitimize via futures and swaps trading on them. Congress nevertheless gave the Commission discretion to allow such contracts to be listed if

trading them would not be contrary to the public interest.

The Nadex Order's incorrect reading of the Special Rule

In the Commission's 2012 Nadex Order[24] ("*Nadex Order*") (*see* Question 5), the Commission applied the Special Rule to contracts on the occurrences of political control and the election of the President of the United States. These occurrences do not involve any of the activities in step two of the Special Rule. Despite this, the *Nadex Order* concluded that the Special Rule applied and prohibited the contracts. The *Nadex Order* adopted the Contract as a Whole view of Step Two, and assumed that the analysis in Step Two considers the Event Contract as a whole, not just the Event Contract's Event. The *Nadex Order* found that the election contracts involved the activity of gaming even though the contract's Event did not, because the act of trading on the contract was gaming and therefore, those contracts, considered as a whole, satisfied Step Two.

This Contract as a Whole view of Step Two that the *Nadex Order* adopted is wrong, and should be rejected. As discussed at length, it violates the structure and the framework of the statute, and it leads to absurd results. The correct view of the statute is that Step Two, like Step One, relates to what the contract is based on, or the contract's Event.

The *Nadex Order's* misreading of the statute would apply to *every* futures and swap contract on an occurrence

The consequence of the Contract as a Whole view of Step Two that the *Nadex Order* adopted is that the Special Rule applies to *all* futures, commodity options, and swap contracts that are based on an occurrence, extent of an occurrence, or a contingency. The *Nadex Order* found that the contracts at issue there were gaming because the act of trading the contracts would fit within state law and federal law definitions of gaming. That same reasoning would apply to *all* futures, commodity options, and swaps that are based on an occurrence, extent of an occurrence, or contingency, because the act of trading these contracts would also fit within definitions of gaming. For example, the *Nadex Order* cited the law in North Dakota that "'Gambling' means risking any money ... upon ... the happening or outcome of an event, including an election .. . over which the person taking the risk has no control."[25] The *Nadex Order* also cited the New Hampshire law that "'Wager' means a monetary agreement between 2 or more persons that a sum of money ... shall be paid to one of them on the happening or not happening of an uncertain event."[26]

The approach the Commission adopted in the *Nadex Order* expands the scope of the Special Rule far beyond what Congress intended. Under the *Nadex Order* and in light of the breadth of some definitions of gaming activity, the Commission could deem the staking of value on any type of future event gaming. Alternatively, the Commission could determine via the authority granted in the Sixth Activity, that trading on any type of future event is similar to the other enumerated activities. The vast breadth of such discretion cannot be squared with the specific enumeration of activities, which Congress clearly designed to cabin the Special Rule's scope.

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[24] CFTC Order Prohibiting North American Derivatives Exchange's Political Event Derivatives Contracts" (Apr. 2, 2012) available here: CFTC Issues Order Prohibiting North American Derivatives Exchange's Political Event Derivatives Contracts | CFTC.

[25] *Nadex Order* fn. 1

[26] It is true that the *Nadex Order* also cited state laws that were more tailored to elections specifically, but that does not negate the point that there are also state laws that define gaming broadly that would include trading any futures, commodity options, or swap contracts that pass step one. Picking and choosing which state statutes to consider informative in a manner that is expedient for a desired outcome is not the proper way for the Commission to adopt its definitional framework.

This reality illustrates the *Nadex Order*'s flaw in going beyond the event underlying the contract -- elections -- to determine whether the contract was gaming.

This argument is addressed in greater detail in Part 2 of this comment. However, the Exchange notes here that this overbreadth is a problem exclusive to the approach to the Contract as a Whole view of Step Two adopted in the *Nadex Order*. Under the more tailored approach where step two of the Special Rule is limited to the contract's Event, this overbreadth disappears..

Applying the three steps of the Special Rule to Kalshi's Contract

Applying the three steps to Kalshi's contract shows that the contract is not subject to the Special Rule.

Kalshi's Contract passes Step One. It is a contract based on the occurrence of political control. The Contract is an Event Contract, meeting the eligibility requirements in Step One, and the analysis proceeds to Step Two.

Step Two is whether the Event Contract's Event involves an activity that was listed in Step Two. The Contract's Event is political control, specifically the dual occurrences of the party membership of the Speaker of the House and the President Pro Tempore. These do not involve any of the listed activities.

- The occurrence of political control does not involve activity that is illegal under either Federal or State Law.
- The occurrence of political control does not involve the activity of terrorism.
- The occurrence of political control does not involve the activity of assassinations.
- The occurrence of political control does not involve the activity of war.
- The occurrence of political control does not involve the activity of gaming.[27]
- The occurrence of political control does not involve an activity that the Commission has determined to be contrary to the public interest.

The Contract's Event, therefore, does not involve an activity that was included by Congress in the list of activities in Step Two of the Special Rule, and therefore the contract fails the Step Two eligibility requirements. The analysis therefore terminates and does not proceed to Step Three, and Congress did not authorize the Commission to apply the Special Rule to prohibit the Contract.

Conclusion to Part 1

Congress granted the Commission in the Special Rule the authority to prohibit certain contracts. This grant of authority is subject to the rules that Congress created. Congress included three distinct steps to determine if a contract is prohibited under the Special Rule. The Commission must abide by these rules. Step Two is clear; the analysis only considers whether the Event Contract's Event involves a listed activity, and it does not consider the Event Contract, as a whole. The Kalshi Contract's Event is political control. Political control does not involve any of the activities that Congress included in Step Two. Accordingly, the Contract fails Step Two, and the Special Rule cannot prohibit the Contract.

[27] The Commission has never stated, or even implied, that the occurrence of elections involves gaming. In the Commission's Nadex order, the Commission stated that "*taking a position* in a Political Event Contract" is gaming because elections are a "a contest between electoral candidates." *See* North American Derivatives Exchange, April 2, 2012 (cftc.gov), pg. 3. However, the Commission was careful to not suggest that elections themselves, the very bedrock and foundation of our democracy, are a game.

As required by the CEA in 7 U.S.C. 7a-2(c)(5)(B), the Commission should approve the Contract.

Part 2

The following two letters contain analyses on the Special Rule, as well as the implementing regulations at 17 C.F.R. 40.11. They were originally submitted to the Commission for consideration as part of the original 40.3 submission, and the Exchange includes them now in a public comment for the Commission's further consideration.

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September 21, 2022

Sebastian Pujol Schott
Acting Deputy Director, Product Review Branch
Division of Market Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
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Re: Non-Application of Event Contracts Provisions to KalshiEX LLC's Political Control Contracts

Dear Mr. Pujol Schott:

I write to you on behalf of KalshiEX LLC ("Kalshi") with respect to its intention to self-certify certain political control contracts (the "Contracts") to be listed for trading on its designated contract market ("DCM"), and to address any outstanding concerns the Commodity Futures Trading Commission ("CFTC" or "Commission"), including the Division of Market Oversight ("DMO"), might have. We greatly appreciate the Commission's and DMO's continued willingness to allow Kalshi to highlight the many reasons why the Contracts should be listed, including the demonstrated economic purposes they serve.

In the spirit of building upon that productive dialogue, and in advance of Kalshi's self-certification of the Contracts, we wanted to elaborate on why Section 5c(c)(5)(C) of the Commodity Exchange Act ("CEA") and CFTC Regulation 40.11 (together, the "Event Contracts Provisions") do not provide a legal basis for the staff or the Commission to impede self-certification of the Contracts.

As further explained below, Section 5c(c)(5)(C)(i) of the CEA does not hinder self-certification of the Contracts because the activity on which they are based does not "involve" any of the enumerated event categories in the provision. Although the Commission previously determined

that other political event contracts that were self-certified by a different exchange, the North American Derivatives Exchange ("Nadex"), were subject to the Event Contracts Provisions, that determination was based on a misinterpretation of the Event Contracts Provisions. Therefore, the Commission's previous determination on Nadex's proposed contracts should not be followed here with regards to the Contracts.[1] Under the Event Contracts Provisions, and contrary to the Commission's order relating to Nadex's political event contracts ("Nadex Order"), which determined that the *trading* of contracts based on the outcomes of elections constituted gaming activity, the Commission must consider whether the occurrence or contingency *on which the Contracts are based* – elections – involves one of the enumerated activities. And because elections do not fit within any of the enumerated event categories, the Event Contracts Provisions provide no basis to delay self-certification. CFTC Regulation 40.11 calls for the same result. Accordingly, even if, arguendo, CFTC Regulation 40.11 contains language that could be construed to support a different result, the Commission should read CFTC Regulation 40.11 to be consistent with Section 5c(c)(5)(C) and, accordingly, the Contracts should be self-certified without delay or encumbrance.

As explained in greater detail below, because the Event Contracts Provisions do not establish any legal or regulatory basis for impeding the Contracts, the Commission should take no action that would delay Kalshi from self-certifying them pursuant to CFTC Regulation 40.2.

I. SECTION 5C(C)(5)(C) OF THE CEA PROVIDES NO BASIS TO IMPEDE SELF-CERTIFICATION OF KALSHI'S POLITICAL CONTROL CONTRACTS.

Section 5c(c)(5)(C)(i) of the CEA establishes that, in connection with the listing of agreements, contracts, or transactions on "excluded commodities that are based upon the occurrence, extent of an occurrence, or contingency[,]"

> the Commission may determine that such agreements, contracts, or transactions are contrary to the public interest if the agreements, contracts, or transactions involve[:] (I) activity that is unlawful under any Federal or State law; (II) terrorism; (III) assassination; (IV) war; (V) gaming; or (VI) other similar activity determined by the Commission, by rule or regulation, to be contrary to the public interest.

Section 5c(c)(5)(C)(ii) further specifies that "[n]o agreement, contract, or transaction determined by the Commission to be contrary to the public interest under clause (i) may be listed or made available for clearing or trading on or through a registered entity." Thus, the CEA, through this

[1] In the Matter of the Self-Certification by North American Derivatives Exchange, Inc. of Political Event Derivatives Contracts and Related Rule Amendments under Part 40 of the Regulations of the Commodity Futures Trading Commission (April 2, 2012), available at: https://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/nadexorder040212.pdf.

provision, establishes a clear framework under which the Commission can – but is not obligated to – review an event contract that is based upon an "occurrence, extent of an occurrence, or contingency" that involves one of the enumerated underlying activities in order to determine if those contracts would be contrary to the public interest. A Commission determination that the contract is contrary to the public interest would render its listing prohibited.

In short, through Section 5c(c)(5)(C), Congress granted the Commission the discretion to determine that a given event contract is contrary to the public interest, and thereby prohibited, only when the event underlying that contract involves one of the statute's specifically enumerated activities. Congress did not grant the Commission the authority to prohibit a contract based upon an event that involves an unenumerated activity on the grounds that it would be contrary to the public interest.[2]

The plain language and structure of Section 5c(c)(5)(C)(i) make clear that the scope of the Commission's discretionary review is narrowly focused on the nature of the contract's underlying event, not of trading in the contract itself. Section 5c(c)(5)(C)(i) begins with the clause: "[i]n connection with the listing of agreements, contracts, transactions, or swaps in excluded commodities *that are based upon the occurrence, extent of an occurrence, or contingency*[.]" (emphasis added). Thus, at the outset of the controlling provision, the statute establishes that the distinguishing feature of the contract is the nature of the occurrence or contingency. The final clause of Section 5c(c)(5)(C)(i), immediately prior to the provision's enumeration of the covered activities, refers back to the first clause of the provision when it says: "the Commission may determine that *such* agreements, contracts, or transactions are contrary to the public interest if the agreements, contracts, or transactions involve" the enumerated activities. (emphasis added). When the clauses are read together, Section 5c(c)(5)(C)(i) grants the Commission only limited authority to review a contract that is "based upon [an] occurrence, extent of an occurrence, or contingency" that "involve[s]" one of the enumerated activities.

The plain language of the enumerated events themselves bolsters this interpretation. As Kalshi has pointed out in previous submissions,[3] Section 5c(c)(5)(C)(i)'s first and sixth categories are defined respectively as an "*activity* that is unlawful under any Federal or State law" and "other similar *activity* determined by the Commission, by rule or regulation, to be contrary to the public interest." (emphasis added). The inclusion of the noun "activity" (and the reference in the sixth

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[2] This lack of authority includes the sixth enumerated activity ("other similar activity determined by the Commission, by rule or regulation, to be contrary to the public interest"), as that provision requires the Commission to conduct a rulemaking to determine that another activity is contrary to the public interest and then only if it is similar to one of the other specified underlying activities (crimes, terrorism, assassination, war, or gaming).
See Commission Rulemaking Explained, available at: https://www.cftc.gov/LawRegulation/CommissionRulemakingExplained/index.htm#_ftn1.

[3] Memorandum in Support of Kalshi's Political Control Contracts, submitted to DMO March 28, 2022.

category to all five preceding "similar activit[ies]") makes clear that Congress intended the underlying activity, not the contract itself, to be the subject of review and scrutiny and it must be assumed that decision was intentional.[4]

The sixth enumerated activity ("other similar activity determined by the Commission, by rule or regulation, to be contrary to the public interest"), further highlights that Congress's intention was for the Commission to analyze the activity underlying the contract rather than trading in the contract itself. This final enumerated activity provides the Commission a sort of catchall to determine whether the event involves "similar activity" to the preceding categories and thus might be inappropriate for listing. Since terrorism, assassination, war, and activity unlawful under state or federal law unquestionably refer to the occurrence or contingency underlying the contract, the sixth catch-all category must be read consistently with the rest of the enumerated list (apples must be compared to apples).[5]

Another reason that Section 5c(c)(5)(C) must be read as focusing on the underlying activity is that such focus is congruent with the nature of event contracts themselves. If Congress was concerned about trading in the contract itself, there is no indication why it would have limited the provision to event contracts rather than establishing a general rule that would have authorized the Commission to prohibit any derivatives contract that the trading in is, for example, unlawful under state law.

In the Nadex Order,[6] the Commission did not interpret Section 5c(c)(5)(C) as focusing on the underlying activity. Instead, the Commission appears to have read the gaming provision (the fifth enumerated activity) to refer to trading in the contract itself. Accordingly, the Commission determined that the gaming provision applied to Nadex's political event contracts because the contracts involved "a person staking something of value upon a contest of others."[7] The Commission likened this trading activity to activity prohibited by state anti-gambling laws. The Commission's interpretation in this instance ran counter to the plain language and structure of the statute, as explained above.

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[4] The scant legislative history – a colloquy between Senators Diane Feinstein and Blanche Lincoln during the Senate's consideration of Dodd-Frank's regulation of event contracts – does not change the analysis. The colloquy did not address whether the underlying event, rather than trading in the contract itself, is the proper subject of analysis; instead, the Senators discussed the distinction in economic purpose between contracts that serve hedging utility and contracts that are designed predominantly for speculation. *See* 56 Cong. Rec. S5906-07 (July 15, 2010) (statements of Sen. Diane Feinstein and Sen. Blanche Lincoln), available at: https://www.congress.gov/111/crec/2010/07/15/CREC-2010-07-15-senate.pdf. In any event, the language and structure of the statute are clear, so resorting to legislative history is unnecessary.

[5] We explain below why, notwithstanding the Commission's Nadex Order, the gaming provision must also refer to the underlying activity and not trading in the contract itself.

[6] *See supra* note 1.

[7] Nadex Order at 3 (internal quotation marks omitted).

Other principles of statutory construction also undercut the application of the Event Contracts Provisions in the Nadex Order. Under the Commission's interpretation, a person trading a political event contract is engaged in gaming – "staking something of value upon a contest of others."[8] By parallel reasoning, a person trading a terrorism contract is engaged in terrorism and a person trading a war contract is engaged in war. That is not a tenable interpretation of the statute. If Congress intended the Commission to focus on the underlying event for some of the enumerated categories, but to focus on trading in the contract itself for others, it would have said so. It certainly cannot be presumed or inferred from silence that Congress intended the Commission to apply disparate analytical approaches to the single list of enumerated activities. When the correct interpretation of Section 5c(c)(5)(C) is applied to the Contracts, the result is clear. Elections are not illegal under state or federal law, are not gaming, and are not similar to any of the enumerated activities – federal or state crimes, terrorism, assassination, war, and gaming – all of which are activities that Congress did not want to legitimize or encourage via event contracts without careful consideration by the Commission. The Commission should therefore not impede Kalshi from self-certifying the Contracts and lacks a legal basis to invoke Section 5c(c)(5)(C) to do so.

While we could stop here, we believe it is worth pointing out that the Nadex Order not only contravenes the language and structure of Section 5c(c)(5)(C), but also threatens to upend the CEA itself. Virtually every futures or swaps contract can be described as staking something of value on the outcome of some future event.[9] Yet the CFTC's exclusive jurisdiction over derivatives markets means that the CEA preempts any state law that would attempt to regulate derivatives markets.[10] Therefore, regulated futures and swaps contracts *cannot be* illegal gambling under state law.

In fact, many states ban "gambling" not just on elections, but more generally on the outcomes of future events. These laws would prohibit the entire category of event contracts (at a minimum), which both Congress and the CFTC have expressly permitted to be listed on DCMs. Some of these states provide carve-outs for CFTC-regulated products, or otherwise for activities like commodities and securities trading. However, not all do. New Hampshire, for example, bans gambling and defines it as, "to risk something of value upon a future contingent event not under one's control or influence."[11] Alaska also bans gambling and defines it similarly as when:

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[8] *Id.*

[9] This overly broad interpretation of the term "gaming" would threaten to render 5c(c)(5)(C)'s other enumerated provisions superfluous, given that, as explained above, virtually all event contracts could potentially qualify for that categorization. As the Supreme Court has repeatedly observed, there is a "canon against interpreting any statutory provision in a manner that would render another provision superfluous." *Bilski v. Kappos*, 561 U.S. 593, 607-8 (2010).

[10] *See Am. Agric. Movement v. Bd. of Trade*, 977 F.2d 1147, 1156-57 (7th Cir. 1992) (holding that "When application of state law would directly affect trading on or the operation of a futures market, it would stand 'as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress,' and hence is preempted." (quoting *Hines v. Davidowitz,* 312 U.S. 52, 67 (1941)).

[11] NH Rev Stat § 647:2(II)(d), available at: https://www.gencourt.state.nh.us/rsa/html/lxii/647/647-2.htm/.

> …a person stakes or risks something of value upon the outcome of a contest of chance or a future contingent event not under the person's control or influence, upon an agreement or understanding that that person or someone else will receive something of value in the event of a certain outcome.[12]

Finally, at least one federal law that addresses gambling specifically carves out regulated derivatives products from their definitions of "bet or wager," highlighting that Congress views the two types of transactions as fundamentally distinct. The Unlawful Internet Gambling Enforcement Act of 2006's ("UIGEA") definition of "bet or wager" specifically "does not include [as relevant here:]"

> (ii) any transaction conducted on or subject to the rules of a registered entity or exempt board of trade under the Commodity Exchange Act;
>
> (iii) any over-the-counter derivative instrument;
>
> (iv) any other transaction that—
>
> (I) is excluded or exempt from regulation under the Commodity Exchange Act; or
>
> (II) is exempt from State gaming or bucket shop laws under section 12(e) of the Commodity Exchange Act or section 28(a) of the Securities Exchange Act of 1934.[13]

Notably, the Commission relied upon UIGEA's definition of "bet or wager" in its Nadex Order,[14] but made no mention of the carve out for derivatives products.

All of these various provisions illustrate the flaw in evaluating whether *trading* a futures or swaps contract constitutes gaming or gambling activity, as the Commission did in the Nadex Order, or whether *trading* a futures or swaps contract is unlawful under federal or state law. Instead, to maintain the structural integrity of Section 5c(c)(5)(C) and the CEA itself, the Commission should evaluate whether the Contracts involve an underlying activity – elections – that fits into one of the enumerated categories of activities in Section 5c(c)(5)(C). Because elections do not

[12] AK Stat § 11.66.280(2).
[13] 31 U.S.C. § 5362(1)(E) (2006).
[14] *Supra* note 1 at 3.

fit within any of the enumerated activities, the Commission should not impede self-certification of the Contracts.

II. CFTC REGULATION 40.11 CALLS FOR THE SAME RESULT.

A determination that Section 5c(c)(5)(C) does not present an obstacle to Kalshi's self-certification of the Contracts should be dispositive, because CFTC Regulation 40.11, which the CFTC adopted to implement Section 5c(c)(5)(C), should likewise be read to allow only for the Commission's consideration of the contract's underlying activity, rather than its consideration of trading in the contract itself. While the language of the rule is not identical to the statute, there is no reason to read the language of CFTC Regulation 40.11 to require an analysis of trading in the contract rather than the contract's underlying activity that constitutes the event.

The scope of CFTC Regulation 40.11 should not be read to go beyond the scope of the special rule in the statute. By using the words "relates to, or references" in addition to "involves," the regulation only reinforces that the relevant activity is the underlying event, not trading on the underlying event. It would not make sense for a futures contract or swap to "reference" trading in the contract; to the contrary, the word "reference" is a clear direction to focus on the underlying event that the contract "references." Thus, under the regulation, like the statute, the relevant activity for purposes of the Commission's event contract analysis is the activity on which the contract is based (or to which the contract refers) rather than the contract itself.[15] Even if the different words in the regulation could conceivably be read to support a different analysis that would broaden the scope of contracts subject to the statute, courts have held that, even under a standard of review that is highly deferential, an agency interpretation will not stand if "it is contrary to clear congressional intent or frustrates the policy Congress sought to implement."[16]

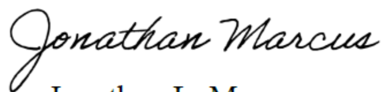
[15] Because the Contracts are not based on an enumerated activity, the Commission does not need to consider undertaking a public interest analysis. If the Commission were to conclude otherwise, however, the Commission could either permit the contracts to be listed (the statute authorizes prohibition only upon a Commission determination that the contract would be contrary to the public interest, a determination that the Commission "may" undertake) or conduct a public interest analysis. CFTC Regulation 40.11 should not be read to constitute a blanket prohibition, as that reading could not be squared with the statute. *See* Statement of Commissioner Dan M. Berkovitz Related to Review of ErisX Certification of NFL Futures Contracts, available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitz-statement040721 ("if sports event contracts involving gaming are found to have an economic purpose, they should be permitted to be listed on a DCM and retail customers cannot be prohibited from trading those contracts"); Statement of Commissioner Brian D. Quintenz on ErisX RSBIX NFL Contracts and Certain Event Contracts, available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement032521 ("Congress [through Section 5c(c)(5)(C) of the CEA] unambiguously provided a default rule that all event contracts, including the enumerated ones, are allowed").

[16] *Garcia Carias v. Holder*, 697 F.3d 257, 271 (5th Cir. 2012); *CHW W. Bay v. Thompson*, 246 F.3d 1218, 1223 (9th Cir. 2001) ("deference is not owed to an agency decision if it construes a statute in a way that is contrary to congressional intent or frustrates congressional policy").

III. Conclusion

For all of the reasons stated above, the Commission has no reason to stay Kalshi's self-certification of the Contracts. We welcome your feedback on this position and would appreciate the opportunity to follow-up on these specific considerations in a conference call or in-person meeting to the extent you have further questions.

Very truly yours,



Jonathan L. Marcus

Cc: Eliezer Mishory
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May 31, 2022

Elie Mishory
KalshiEx LLC
594 Broadway
New York, NY 10012

Re: Political Event Contracts, Section 5c(c)(5)(C) of the CEA, and CFTC Rule 40.11

Dear Mr. Mishory:

This letter is in response to your request for legal advice regarding KalshiEx LLC's ("Kalshi") engagement with the Commodity Futures Trading Commission ("CFTC" or "Commission") about the listing of certain event contracts relating to the partisan makeup of Congress, specifically the political control of Congress. One of the factors that Kalshi considers in listing contracts is ensuring regulatory compliance and, as such, you requested advice on the following question:

> Are Kalshi's proposed political control contracts subject to the Commodity Exchange Act's ("CEA's") special rule for event contracts described in Section 5c(c)(5)(C) of the CEA and the implementing regulations at 17 C.F.R. § 40.11?

By way of background, in 2012, Nadex listed similar contracts (although with different characteristics) which the Commission prohibited by order ("Nadex Order"),[1] finding that trading in the Nadex contracts violated the CEA. Specifically, the Nadex Order found that Section 5c(c)(5)(C) of the CEA applied to the Nadex contracts because the Nadex contracts constituted gaming.[2] The Nadex Order also determined that the Nadex contracts were contrary to the public interest because the Nadex contracts could have an adverse effect on the integrity of elections.[3]

Section 5c(c)(5)(C) and Rule 40.11, however, are limited to only the underlying activity (not participating in the contract itself) and, because Kalshi's political control contracts do not match

[1] In the Matter of the Self-Certification by North American Derivatives Exchange, Inc. of Political Event Derivatives Contracts and Related Rule Amendments under Part 40 of the Regulations of the Commodity Futures Trading Commission (Apr. 2, 2012) (https://www.cftc.gov/sites/default/files/stellent/groups/public/@rulesandproducts/-documents/ifdocs/nadexorder040212.pdf) (last visited May 30, 2022).

[2] Nadex Order at 2-3.

[3] *Id.* at 4.

any of the enumerated activities which the statute is expressly limited to, those contracts are not subject to the statute and implementing regulation. In reaching this conclusion, I will first provide some background of principles of interpretation and the relevant text of Section 5c(c)(5)(C) and Rule 40.11. I will then apply those principles to the Kalshi political control contracts and describe how the Nadex Order's conclusions to the contrary are incorrect.

I. BACKGROUND

A. Principles of Interpretation

Since the Nadex Order, the Supreme Court has significantly modified the method through which regulatory text should be interpreted and the circumstances in which an agency will receive deference for its interpretation of regulatory text. The tools for interpreting regulatory text are similar to those for evaluating statutory text. I first discuss these principles and then use them to evaluate Section 5c(c)(5)(C) and CFTC Rule 40.11 and their application to Kalshi's political event contracts.

The Supreme Court revamped the process for evaluating regulatory text in the 2019 case of *Kisor v. Wilkie*.[4] In *Kisor*, the court considered whether to overrule *Auer v. Robbins*[5] and *Bowles v. Seminole Rock*,[6] cases which found that an agency was entitled to deference of its interpretation of an agency rule so long as it was not "plainly erroneous or inconsistent with the regulation."[7] In *Kisor*, the Court did not overrule *Auer* and *Seminole Rock*, but significantly limited their application: "The deference doctrine we describe is potent in its place, but cabined in its scope."[8]

In reviewing the meaning of Rule 40.11, according to *Kisor*, one must "exhaust the 'traditional tools' of statutory construction.'"[9] "Agency regulations can sometimes make the eyes glaze over. But hard interpretive conundrums, even relating to complex rules, can often be solved."[10] One must "resort[ ] to all the standard tools of interpretation,"[11] including a careful consideration of

[4] 139 S. Ct. 2400 (2019).

[5] 519 U.S. 452 (1996).

[6] 325 U.S. 410 (1945).

[7] *Seminole Rock*, 325 U.S. at 414.

[8] *Kisor*, 139 S. Ct. at 2408.

[9] *Id.* at 2415 (quoting *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843, n. 9 (1984)).

[10] *Kisor*, 139 S. Ct. at 2415.

[11] *Id.* at 2414.

"the text, structure, history, and purpose of a regulation"[12] to determine whether a rule has "one reasonable construction of a regulation"[13] or can "at least establish the outer bounds of reasonable interpretation."[14] In discussing this approach to regulatory construction, the Supreme Court relied heavily on the principles of statutory construction discussed in *Chevron* and its progeny.

B. The Statute And The Rule

With these key principles in mind, I turn to the statute and rule. This analysis begins, of course, with the statutory text of Section 5c(c)(5)(C) of the CEA, from which the CFTC promulgated Rule 40.11. That section of the CEA states:

> In connection with the listing of agreements, contracts, transactions, or swaps in excluded commodities that are based upon **the occurrence, extent of an occurrence, or contingency** (other than a change in the price, rate, value, or levels of a commodity described in section 1a(2)(i) [2] of this title), by a designated contract market or swap execution facility, the Commission **may determine** that such agreements, contracts, or transactions are contrary to the public interest **if** the agreements, contracts, or transactions **involve**—
>
> (I) **activity** that is unlawful under any Federal or State law;
> (II) terrorism;
> (III) assassination;
> (IV) war;
> (V) gaming; or
> (VI) **other similar activity** determined by the Commission, by rule or regulation, to be contrary to the public interest.[15]

In relevant part for purposes of this analysis, Rule 40.11(a) states:

> A registered entity shall not list for trading or accept for clearing on or through the registered entity any of the following:
>
> (1) An agreement, contract, transaction, or swap based upon an excluded commodity, as defined in Section 1a(19)(iv) of the Act, that **involves, relates to,**

[12] *Id.* at 2415.

[13] *Id.*

[14] *Id.* at 2416. The *Kisor* court goes on to explain that an agency's interpretation of an ambiguous regulation may still not receive deference. The Court must then determine if "the character and context of the agency interpretation entitles it to controlling weight." *Id.*

[15] 7 U.S.C § 7a-2(c)(5)(C)(i)(I)-(VI) (emphases added). If the Commission determines that such an agreement, contract, or transaction is contrary to the public interest, such agreement, contract, or transaction may not "be listed or made available for clearing or trading on or through a registered entity." *Id.* § 7a-2(c)(5)(C)(ii).

> **or references** terrorism, assassination, war, gaming, or an **activity** that is unlawful under any State or Federal law; or
> (2) An agreement, contract, transaction, or swap based upon an excluded commodity, as defined in Section 1a(19)(iv) of the Act, which involves, relates to, or references **an activity that is similar to an activity** enumerated in § 40.11(a)(1) of this part, and that the Commission determines, by rule or regulation, to be contrary to the public interest.[16]

II. APPLICATION TO KALSHI'S POLITICAL CONTROL CONTRACTS

To help frame the matter, the key question here requires understanding the limitations on the scope of Section 5c(c)(5)(C) and Rule 40.11. Is the scope (1) limited to contracts when the activity underlying the event contract involves one of the enumerated activities or do they (2) include the act of participating in the contract is itself?

Applying the principles of statutory and regulatory construction shows that Section 5c(c)(5)(C) and Rule 40.11 are limited to only the underlying activity (not participating in the contract itself) and, because Kalshi's political control contracts do not match any of the enumerated activities which the statute is expressly limited to, those contracts are not subject to the statute and implementing regulation.

A. Section 5c(c)(5)(C) and Rule 40.11 Apply Only To Event Contracts Where The Activity Underlying The Event Contract Is One Of The Enumerated Activities.

The plain text of Section 5c(c)(5)(C) demonstrates that Congress limited the statute's scope to instances where the underlying activity of an event contract is one of the enumerated events. If the activity underlying the event contract does not involve one of the enumerated activities, the listing is outside the scope of the Statute and Rule 40.11, regardless of how the act of *participating* in the event contract itself is classified. An interpretation of the statute that extends the applicable scope to also include contracts where the underlying activity is not one of the enumerated events is overbroad and incorrect.

First, Section 5c(c)(5)(C) limits the scope of the Commission's authority to "activities" and activities only. The Commission only has discretion to take action on (1) an "activity" that is unlawful under federal or state law; (2) one of four specifically listed "activities" (terrorism, assassination, war, or gaming); or (3) other similar "activity" determined by the Commission to be contrary to the public interest. The Commission itself has previously acknowledged that Section 5c(c)(5)(C)'s textual focus is on "activities," *i.e.*, the underlying conduct. In describing Section

[16] 17 C.F.R. § 40.11(a) (emphases added).

5c(c)(5)(C), the Commission stated that the rule applied to contracts that "involve one or more *activities* enumerated in the Dodd-Frank Act."[17] These "activities" are not the contracts themselves. They are the events that create the basis for the relevant contract.

To give but one straightforward example, in the statute events two through four are terrorism, assassination, and war. The inclusion of these activities clearly demonstrates that the scope of Section 5c(c)(5)(C) and Rule 40.11 includes contracts when the activity underlying the event contract involves one of the enumerated activities. The act of participating in a contract is not itself an act of terrorism, assassination, or war.[18] The same analytical approach, by extension, should apply to each of the items on the list, including an "activity that is unlawful under any Federal or State law" and "gaming." Otherwise, Section 5c(c)(5)(C) would be internally inconsistent, contrary to the traditional tools of construction.

Second, Section 5c(c)(5)(C) and Rule 40.11 allow the Commission to prohibit the listing of an event contract only "if the agreements, contracts, or transactions **involve**" any of the enumerated activities that are against the public interest. Event contracts that do not involve any of the enumerated activities may be listed for trading because the special rule would not prohibit the listing of those contracts by a DCM.

Third, Section 5c(c)(5)(C) places an additional, key limitation on the "agreements, contracts, or transactions" within the scope of the text. Those "agreements, contracts, or transactions" must be "in excluded commodities that are based upon the occurrence, extent of an occurrence, or contingency." The reference to "occurrence" or "contingency" can only mean to the underlying event of the contract, not the contract itself. The contract cannot reasonably be described as an occurrence or a contingency. Indeed, the headings of the section—"Special rule for review and approval of event contracts and swap contracts" (Section 5c(c)(5)(C)) and "Event Contracts" (Section 5c(c)(5)(C)(i))—reinforce Congress' focus on the "event" or occurrence, not the trading

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[17] *Provisions Common to Registered Entities: Proposed Rule*, 75 Fed. Reg. 67,282, 67,283 (Nov. 2, 2010) ("Section 745 of the Dodd-Frank Act also authorizes the Commission to prohibit the listing of event contracts based on certain excluded commodities if such contracts involve one or more **activities** enumerated in the Dodd-Frank Act.") (emphasis added) ("40.11 Proposed Rule"); *see id.* at 67,289 ("If [] the Commission determines that such product may involve an **activity** that is enumerated in 40.11 . . . .") (emphasis added).

[18] To illustrate this point, consider hypothetical contracts on whether a foreign leader will be assassinated, how many Russian planes will be shot down by Ukrainian forces, or how many murders will occur in a given city over a certain time period. Section 5c(c)(5)(C) and Rule 40.11 would apply to these hypothetical contracts because the activities underlying the contracts in these hypothetical examples are the enumerated activities of "assassination," "war," and "an activity that is unlawful under Federal or State law." The purchasing of the contract itself, however, is not "an activity" of "assassination," "war," or "an activity that is unlawful under Federal or State law."

of the contract. Thus, the text and structure of Section 5c(c)(5)(C) clearly and meaningful limit the Commission's reach regarding event contracts.

Because the text and structure is clear, there is no need to resort to legislative history. That is a bedrock principle of the traditional tools of statutory construction. Nevertheless, the sparse legislative history regarding Section 5c(c)(5)(C)[19] provides no guidance as to whether Congress intended the Commission to limit the scope of Section 5c(c)(5)(C) to instances where the underlying activity of an event contract is one of the enumerated events.

This reading of Section 5c(c)(5)(C) is consistent with the terms used by the Commission in Rule 40.11. Rule 40.11 borrows heavily from the terms used in the statute, including multiple uses of "activity" in both subsections 40.11(a). The Regulation also uses the same term "involves" which appears in the Statute, but also adds the phrase "relates to, or references" when describing enumerated activities. Because "involves" is the only statutory authority provided by Congress, the Commission cannot expand upon the scope of that term. Thus, the only way to read "relates to, or references" consistent with the Commission's authority is that they are the specific meanings of "involves" that the Commission adopted.[20] The terms "relates to" and "references," in turn, clearly describe the underlying activity upon which the event contract is based. It would be nonsensical to interpret "relates to" and "references" as describing the act of participating in the event contract itself.

To be clear, Congress could certainly promulgate a law that covers the *participation* in an event contract. But Section 5c(c)(5)(C) is not that law. Instead, applying the traditional tools of construction, Congress enacted Section 5c(c)(5)(C) to prohibit a narrow group of contracts whose underlying activities are the enumerated activities and the CFTC has determined are contrary to

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[19] The only legislative history that has been cited by the Commission regarding Rule 40.11 involves a short colloquy between Senator Feinstein of California and Senator Lincoln of Arkansas on July 15, 2010. *See, e.g.,* 40.11 Final Rule, 76 Fed. Reg. at 44,786 & nn. 34-35; *see also* Nadex Order, Whereas Clauses 2 & 7. This 555-word back-and-forth between two Senators, which takes up less than two columns of one page of the Congressional Record (Volume 156, Issue 105, S5906-5907 (July 15, 2010)), is particularly weak evidence of the intent of Congress as a whole and the meaning of the provision. *See, e.g., NLRB v. SW General, Inc.,* 137 S. Ct. 929, 943 (2017) ("[F]loor statements by individual legislators rank among the least illuminating forms of legislative history."). The text is by far the more probative evidence of Congress' meaning. The Nadex Order's extensive reliance on this sparse legislative history is simply inconsistent with the interpretive approach laid out in *Kisor* and provides an additional reason why Kalshi can self-certify the contracts notwithstanding the Nadex Order. In any event, none of the short legislative history specifically addresses the question about whether Section 5c(c)(5)(C) applies only to the underlying events or the trading of the contracts as well, so it has nothing to add to this analysis.

[20] Rule 40.11 cannot exceed the scope of Section 5c(c)(5)(C). Any interpretation of Rule 40.11 that views it as expanding the scope delineated in Section 5c(c)(5)(C) would run afoul of the Constitution's separation of powers and the Administrative Procedure Act.

the public interest and those limitations apply to Rule 40.11. If the underlying activity of a contract is not an enumerated event, it is outside the scope of Section 5c(c)(5)(C) and Rule 40.11.

B. The Nadex Order Incorrectly Interprets And Applies Section 5c(c)(5)(C) And Rule 40.11 To Apply To Political Control Contracts Like Kalshi's.

As described above, Section 5c(c)(5)(C) and Rule 40.11 apply only to the listing of event contracts whose underlying activity involves one of the six enumerated activities. They do not apply to event contracts whose underlying activity does not involve one of the enumerated activities. This key distinction between the activity itself or a *contract on the activity* is of particular importance for the Kalshi contracts at issue here. The underlying activity of Kalshi's contracts is political control of the chambers of Congress. Political control of Congress is none of the activities identified in Section 5c(c)(5)(C) and, as such, Kalshi's political control contracts are not subject to the special rule.

The Nadex Order's contrary conclusion was incorrectly reasoned and misapplied in several aspects.[21] First, contrary to the above explanation, the Nadex Order incorrectly expanded the scope of the statute and regulation to include the act of participating in the contract, and not just the underlying activity. Second, the Nadex Order incorrectly includes election contracts in the enumerated activities of illegal under state law and gaming.

The Nadex Order incorrectly expanded the scope of Section 5c(c)(5)(C) and Rule 40.11 to include the act of participating in the contract, and not just the underlying activity. The first enumerated activity of Section 5c(c)(5)(C) is "activity that is unlawful under any Federal or State law." The underlying activity of Kalshi's contracts is political control of the chambers of Congress. There is no Federal or State law that makes political control of Congress illegal. There is also no Federal or State law that prohibits elections or voting in elections which result in the political control of Congress. Accordingly, political control contracts would not fall under the special rule's enumerated act of "illegal activity."

To be sure, 27 states do prohibit, in one form or another, betting on elections. And the Nadex Order (incorrectly) stated that "state gambling definitions of 'wager' and 'bet' are analogous to the act of taking a position in the Political Event Contracts"[22] as a justification for prohibiting those contracts' listing. In this regard, however, the Nadex Order overextended. Section 5c(c)(5)(C) is limited to the activity underlying the contract, not the participation in the contract itself.

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[21] As noted previously (*see supra* nn. 4-14), the Commission adopted the Nadex Order prior to the Supreme Court's decision in *Kisor v. Wilkie* and thus the Order did not use the framework now required by the Supreme Court for evaluating the scope and implications of Rule 40.11.

[22] Nadex Order at 2.

The Nadex Order also misapplies the enumerated activity of "gaming." There are at least two fundamental differences between the relevant state gaming or gambling laws and event contracts. As Commissioner Brian Quintenz described with regards to the withdrawn ErisX sports event contract, trading an event contract with a binary outcome is not automatically considered a gamble.[23] Indeed, if Section 5c(c)(5)(C) had assumed that participating in any event contract involved making a wager or gamble, there would have been no need for Congress to individually enumerate "gaming" as a distinct category of event contracts upon which the Commission could make a public interest determination. The fact that Congress separated "gaming" from other event contracts is a clear indication that Congress did not intend for all event contracts to be considered gaming.

In fact, the statutory definition of "bet" or "wager" used by the Nadex Order itself, in the same statute, clearly indicates that not all CFTC regulated products are gaming. The statute cited by the Nadex Order[24] for defining "bet" or "wager" is 31 U.S.C. § 5362(1), a part of the Unlawful Internet Gambling Enforcement Act of 2006. That definition of "bet or wager," however, includes two relevant exclusions. First, the term "bet or wager" does not include "any transaction conducted on or subject to the rules of a registered entity or exempt board of trade under the Commodity Exchange Act."[25] The term also does not include "any other transaction that is excluded or exempt from regulation under the Commodity Exchange Act."[26] The statute cited by the Nadex Order itself demonstrates that the Nadex Order's expansive application of Section 5c(c)(5)(C) and Rule 40.11 is incorrect.

The Nadex Order's broad interpretation of gaming under the statute and rule would result in prohibiting much of the legally registered activity that the CFTC has previously approved. Indeed, many states ban "gambling" not just on elections, but specifically on the outcomes of future events. For example, New Hampshire bans gambling and defines it as "to risk something of value upon a future contingent event not under one's control or influence"[27] while North Carolina includes a

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[23] *See* Statement of Commission Brian D. Quintenz on ErisX RSBIX NFL Contracts and Certain Event Contracts (Mar. 25, 2021) (available at https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement032521) (last visited May 30, 2022). The many other distinctions between an event contract and a gamble include the fact that betting is a game of pure chance without any economic utility while event contracts are non-chance driven outcomes with economic utility.

[24] Nadex Order at 3.

[25] 31 U.S.C. § 5362(1)(a)(E)(ii).

[26] *Id.* § 5362(1)(a)(E)(iv)(I).

[27] NH Rev Stat § 647:2(II)(d) (2017); *see also* Alaska Stat. § 11.66.280(3) ("gambling" means that a person stakes or risks something of value upon the outcome of a contest of chance or a future contingent event not under the person's control or influence, upon an agreement or understanding that that person or someone else will receive something of

wager on an "unknown or contingent event" in its statutory definition of gambling.[28] New York defines gambling as staking or risking something of value upon the outcome of a contest of chance or a future contingent event not under his control or influence, upon an agreement or understanding that he will receive something of value in the event of a certain outcome.[29] Other states explicitly prohibit trading on the future delivery of securities and commodities without delivery and which are purely cash-settled, as is normal for products like stock index futures and eurodollar futures.[30] In all, 19 states contain provisions in their state codes that prohibit the listing of at least some subset of contracts that the CFTC has approved.[31]

Under the Nadex Order's reasoning, because Rule 40.11 prohibits the listing of contracts that "involve" "gaming," laws like these would prohibit ***all*** event contracts. For example, event contracts on the weather and various economic indicators would be considered "risking something of value upon a future contingent event not under one's control or influence." And yet, not only are these event contracts a staple of CFTC regulated DCMs, but the Commission's Core Principles require that event contracts be specifically outside the control or influence of a market participant and not readily susceptible to manipulation. The Nadex Order's application of Rule 40.11 would therefore preclude the CFTC from regulating any event contract because event contracts are considered gambling under (some) state laws.[32] Because such an interpretation of "gaming" would lead to absurd results, the traditional tools of interpretation and the process required by the

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value in the event of a certain outcome"); Or. Rev. Stat. § 167.117(7) ("'Gambling' means that a person stakes or risks something of value upon the outcome of a contests of chance or a future contingent event not under the control or influence of the person . . .").

[28] N.C. Gen. Stat. § 16-1.

[29] NY Penal Law, Chapter 40, Part 3, Title M, Article 225.

[30] For example, the laws of South Carolina, Oklahoma, and Mississippi use the following language: "Any contract of sale for the future delivery of cotton, grain, stocks or other commodities . . . upon which contracts of sale for future delivery are executed and dealt in without any actual bonafide execution and the carrying out or discharge of such contracts upon the floor of such exchange, board of trade, or similar institution in accordance with the rules thereof, shall be null and void and unenforceable in any court of this state, and no action shall lie thereon at the suit of any party thereto."

[31] Moreover, the purpose of the CEA, CFMA and other laws was to create clear and consistent national guidelines; a contrary interpretation would lead to the undesirable result that if one state prohibited a specific kind of contract then the Commission could use the special rule to ban that contract in all states.

[32] On this point, it seems that at the very least, Rule 40.11 would be an APA violation, or even unconstitutional, if the analysis in Nadex Order was taken to its logical conclusion because of its dramatic impacts on the regulatory scheme. *Cf. Whitman v. American Trucking Ass'ns, Inc.*, 531 U.S. 457, 468 (2001) ("Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes.").

Supreme Court in *Kisor* demonstrate that the Nadex Order's view cannot be the correct way to interpret Rule 40.11.[33]

Seen in this context, the state laws that prohibit gambling on elections do not and cannot refer to CFTC regulated event contracts. The laws of many states prohibit gambling on event contracts, case-settled commodity futures contracts, and elections as one. Yet, the CFTC clearly continues to regulate and approve of the event contracts and cash-settled commodity futures markets even though it may seem to conflict with those state laws.[34] Event contracts relating to elections should be no different. Indeed, just as other event contracts regulated by the CFTC, Kalshi's political control contract should also not be precluded by the gaming provisions of Rule 40.11.

Furthermore, the CFTC's actions and inactions since the Nadex Order indicate that even the Commission has not continued the Nadex Order's reasoning in this regard. Consider, for example, the Small Cannabis Equity Index Futures Contract listed by the Small Exchange. The Cannabis Index involves the stock prices of companies in the cannabis industry that produce and distribute cannabis for consumption—an activity that is unlawful under Federal law and many State laws. The contract is "dependent on the occurrence, nonoccurrence, or the extent of the occurrence" of an event with "potential financial, economic, or commercial consequence,"[35] namely the value of the Cannabis Index. The activities of these companies are production and distribution of cannabis for consumption, which are all activities that are "unlawful under Federal and [many] State laws,"

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[33] *See, e.g., Tennessee Wine & Spirits Retailers Ass'n v. Thomas*, 139 S. Ct. 2449, 2462 (2019) ("reading § 2 [of the Twenty-First Amendment] to prohibit the transportation or importation of alcoholic beverages in violation of *any* state law would lead to absurd results that the provision cannot have been meant to produce") (emphasis in original). Indeed, the "Commission agrees that the term 'gaming' requires further clarification and that the term is not susceptible to easy definition." *Provisions Common to Registered Entities: Final Rule*, 76 Fed. Reg. 44,776, 44,785 (July 27, 2011). In the 40.11 Final Rule, the Commission noted that it had previously sought comments regarding event contracts and gaming in 2008 and that the "Commission continues to consider these comments and may issue a future rulemaking concerning the appropriate regulatory treatment of 'event contracts,' including those involving 'gaming.'" 40.11 Final Rule at 44,785. "In the meantime, the Commission has determined to prohibit contracts based upon the activities enumerated in Section 745 of the Dodd-Frank Act and to consider individual product submissions on a case-by-case basis under 40.2 or 40.3." *Id.* That process is undermined if the Nadex's Order's approach to "gaming" stands.

[34] The CFMA explicitly preempts the application of state gambling statutes when it applies to legal commodity futures contracts and as such there is also a federal preemption argument here that the state gambling statutes should not be considered, regardless of the Nadex Order's misapplication of Rule 40.11. *See* 7 U.S.C. § 16(e)(2) ("This chapter shall supersede and preempt the application of any State or local law that prohibits or regulates gaming or the operation of bucket shops (other than antifraud provisions of general applicability) in the case of—(A) an electronic trading facility excluded under section 2(e) of this title; and (B) an agreement, contract, or transaction that is excluded from this chapter under section 2(c) or 2(f) of this title or sections 27 to 27f of this title, or exempted under section 6(c) of this title (regardless of whether any such agreement, contract, or transaction is otherwise subject to this chapter).").

[35] *See* 7 U.S.C. § 1a(19) (definition of excluded commodity).

and should otherwise fall under the purview of Section 5c(c)(5)(C) and Rule 40.11. Certainly, if Section 5c(c)(5)(C) was given the same broad reading that the Commission gave to it in the Nadex Order, the Cannabis Equity Index would certainly "involve" an enumerated activity and be subject to Section 5c(c)(5)(C) and Rule 40.11. Yet, the Cannabis Index contract was self-certified and the Commission did not invoke Section 5c(c)(5)(C) or Rule 40.11. Therefore, it is clear that the Commission has not maintained the Nadex Order's overbroad and incorrect reading of the Statute and Rule 40.11.

Even if the proposed Kalshi contracts somehow came within the scope of Section 5c(c)(5)(C) and Rule 40.11, that does not preclude them from being listed. I understand that Kalshi has made submissions to the Commission demonstrating offering the contracts would be in the public interest. A full discussion of those points is outside the scope of this letter. I do note, however, that the Commission is not limited to using an economic purpose test for determining whether a contract is within the public interest. That test is found nowhere in the text of Section 5c(c)(5)(C) or Rule 40.11. One reference to the economic purpose test between two Senators in a brief discussion of what would become Section 5c(c)(5)(C) is insufficient to bind the Commission to that test.[36] The Commission recognized as much in the Nadex Order itself, stating "the Commission has the discretion to consider other factors in addition to the economic purpose test in determining whether an event contract is contrary to the public interest."[37]

Furthermore, as a procedural matter, there is nothing in the CEA or Rule 40.11 requiring the Commission to act on Kalshi's self-certification of the political control contracts discussed in this letter. Both Section 5c(c)(5)(C) and Rule 40.11 speak in terms that the Commission "may determine."[38]

At the end of the day, Kalshi has various arguments to justify the self-certification of the contracts described above.

[36] *See* supra note 19 (discussing limitations of floor statements as persuasive evidence of a statute's meaning).

[37] Nadex Order at 4.

[38] 7 U.S.C. § 7a-2(c)(5)(C)(i) ("the Commission **may determine** that such agreements, contracts, or transactions are contrary to the public interest . . .") (emphasis added); 7 C.F.R. § 40.11(c) ("The Commission **may determine** . . . that a contract . . . be subject to the 90-day review.") (emphasis added).

Please let me know if you need anything further.

Sincerely,

Daniel J. Davis

Daniel J. Davis

DJD:dml