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June 30th, 2008

Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St. N.W.
Washington DC 20581
Attention: Office of the Secretariat

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

JURISDICTION AND EVENT MARKETS IN GENERAL

Given the explicit statutory definitions of "excluded" and "exempt" commodities, it is reasonable to conclude that the U.S. Commodity Futures Trading Commission ("CFTC") has jurisdiction over all exchange-traded event markets. That is, if an "occurrence, extent of occurrence or contingency" does not meet the additional "beyond the control" and "economic consequence" criteria, then contracts on such events should be considered exempt commodities. While currently all exempt commodities are associated with a deliverable other than cash, the open-ended definition of "exempt commodity" considered alongside the definitions of "commodity" and "excluded commodity" in 7 U.S.C. § 1a imply that contracts on events that are not beyond the control of participants or do not involve an outcome of economic consequence are exempt commodities.

This conclusion presents enforcement issues that the CFTC may wish to avoid, such as being obligated to pursue actions against exchanges offering contracts based on the outcome of sporting events. Unfortunately, without further statutory clarification, this conclusion seems like the most defensible one, based on the letter, if not the intent, of the law.

That said, until statutory clarification is attained, given the purposes and history of the Commodity Exchange Act ("CEA"), it would be appropriate for the CFTC to only assert jurisdiction over those event contracts satisfying "economic consequence" criteria, which would include the price discovery aspect of the former economic purpose test. An interpretation to this effect by the CFTC would not be inconsistent with the text of the CEA, and would best serve to minimize the burden on interstate commerce. This policy decision would effectively reconstitute the pre-Commodity Futures Modernization Act economic purpose test for event contracts in a way that avoids unwanted enforcement issues. Such a decision would be unlikely to meet significant resistance until such time that further statutory certainty is forthcoming.

The CFTC would be free to classify such contracts as either excluded or exempt commodities depending on their susceptibility to manipulation, before or after special

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trading prohibitions are in place. Although the anti-manipulation requirements that apply to exempt commodities are directed towards price manipulation, *a fortiori* they must also apply to outcome manipulation. [2]

The CFTC is free to determine what qualifies as "economic consequence." As with the economic purpose test, significant hedging and price discovery functions would comprise the principal criteria. [3] Regarding the latter, since event derivatives have no corresponding "cash" markets, the origination of prices that may improve economic decisions is all the more desirable in these cases. Furthermore, events that may only directly affect a group of private individuals may also have a strong bearing on commercial decision-making. Note that some general events and measures, as categorized and listed by the CFTC in its Concept Release, do in fact correspond to economic measures. [4] Even if these events do not predictably correlate with asset prices, they may have predictable effects on market volatility. For example, from 1980 through present, the annualized weekly volatility of the S&P 500 in weeks in which a presidential or mid-term election took place was 19.97%, vs. 15.34% for all other weeks. [5] It is difficult and ultimately undesirable to provide a quantitative recommendation for a bright-line demarcation between those markets that would satisfy an economic consequence criterion and those that would not. However, if a significant statistical test can easily be found that includes the price series of a more familiar asset, and has a logical basis, we can reasonably say that such events are associated with an economic consequence. In many cases the relevant time series may be unavailable, but in those cases the applicability of a proposed event market to other assets may be obvious. For example, consider a market predicting the likelihood of: (1) ethanol-related legislation, and its relationship to corn prices, or (2) offshore drilling legislation, and its relationship to oil prices, or (3) an attack on Iran, and its relationship to oil prices, or (4) future tax rates, and its relationship to municipal bond prices. In such cases, no quantitative test is necessary. In other cases, we may have moderately strong reasons to suspect that a given event or measure has an impact on asset prices, as we do with demographic trends, but those effects may be difficult to measure empirically.

Many potential markets may improve decision-making for a particular business, but have little bearing on the broader economy and asset prices in general. Examples of these markets include those predicting: (1) the revenue of a particular product, published title, film or performance series, (2) the launch or completion date of a particular product or project, and (3) the success of a particular approach applied to certain problem. The CFTC may find that only broad-based events or measures affecting an entire population,

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[2] For example, a market on infrequent terrorist attacks would not be approved for the simple reason that outcome manipulators could not reliably be identified beforehand.

[3] cf. Robert Hahn and Paul Tetlock, "A New Approach for Regulating Information Markets," *AEI-Brookings Joint Center Working Paper* (December 2004).

[4] Justin Wolfers and Eriz Zitzewitz, "Using Markets to Inform Policy: The Case of the Iraq War," *NBER Working Paper* (June 2004).
Justin Wolfers, Erik Snowberg and Eric Zitzewitz. "Partisan Impacts on the Economy: Evidence from Prediction Markets and Close Elections," *NBER Working Paper* (March 2006).
Erik Snowberg, Justin Wolfers and Eric Zitzewitz, "Party Influence in Congress and the Economy," *Quarterly Journal of Political Science*: Vol. 2: No 3, pp 277-286 (2007).

[5] F-test ($\alpha = 0.1124$). If we instead only consider the Wednesdays following election day compared to all other days over this same period, $\alpha = 0.0246$.

industry or significant percentage thereof would satisfy the economic consequence criteria. This would be nothing new, as commodity derivatives were not intended to be specialized insurance contracts. Such narrow questions also present issues from a manipulation and insider-trading perspective. In aggregate, these sorts of questions are quite relevant to the economy and will at times reflect broad trends, but may be more appropriately served by over-the-counter arrangements or riskless information aggregation, despite the obvious advantages of market incentives.

Contracts satisfying economic consequence criteria need not be approved for listing by the CFTC, though it is hoped that guidelines will be made public and remain flexible. At the limit, the CFTC will recognize that even a purely speculative market might serve an economic purpose in reducing portfolio variance.

Additionally:

The CFTC might levy a special fee on regulated event contracts to recoup expenditures related to a trading prohibition facility and other special demands on resources.

It may be required that exchanges pay interest on binary event contract collateral in order to reduce price distortions near extreme prices (100% and 0%). In illiquid markets, such distortions could be used to disguise transfers of money between anonymous participants.

The CFTC should welcome Securities and Exchange Commission opinion on contracts based on events like earnings and dividend announcements, a group of which might begin to replicate a security. Whenever a market is proposed that reflects the cash flow of a particular business or property, this opinion may be relevant.

To the extent that they subsequently conform to the CEA and CFTC policy, amnesty for any past violations should be considered with respect to Intrade and similar exchanges that have operated legally in their domestic jurisdictions.

ELECTION AND POLICY EVENT CONTRACTS

Election and policy event markets are within the jurisdiction of the CFTC based on the letter and spirit of the CEA. These markets represent the largest reasonably predictable yet unhedgeable risk facing businesses and the public. The regulation of such markets follows from the history of enlightened, flexible innovation exemplified by the CFTC.

Because of their importance, election and policy event contracts naturally involve special consideration, although only in the course of satisfying the CEA.

Considering election contracts:

Trading prohibitions should be established such that candidates and proxies cannot participate due to their ability to determine the outcome of the contract. In addition to adhering to the "beyond the control" requirement of excluded commodities and general anti-manipulation precepts, the CFTC will want to consider to what extent such prohibitions might be expanded to act as insider trading restrictions similar in form to those of 7 U.S.C. § 13(f) or the proposed H.R. 2341. [6] Especially given the all-or-nothing nature of many event contracts, this might be desirable in order to provide for fair and equitable trading. [7]

Upon the death of a candidate, the candidate's contracts and those of all competitors must settle on the last known price before the event. A new set of contracts reflecting the new set of candidates could subsequently be offered. [8]

Analogous rules could be applied to policy and legislative contracts where appropriate. These rules, either directly administered by the CFTC and related associations, and/or required of exchanges, would firmly address outcome manipulation.

Because of their importance and sensitivity, these contracts also require special measures to ensure against price manipulation. However, it is important to note that election and policy markets have typically been traded as binary event options. Such contracts expire at a specific time according to a well-defined objective event and in that way are more resistant to manipulation than futures and perpetuities, the prices of which are unbound in one direction and always open to interpretation based on unobservable factors and developments in related markets. At the same time, the relative detachment of event contracts from the web of more familiar asset prices may make manipulation more difficult to prove.

As would be expected, large trader lists could be maintained and closely followed. A more powerful option is the enforcement of extraordinarily low position limits, which would greatly reduce the potential of price manipulation. At the same time, position limits should respect outstanding risks participants may have and be otherwise unable to hedge, as with traditional hedging and speculative limits. Low position limits also address trader protection concerns if such contracts were to be offered in a non-intermediated fashion. Leverage might likewise be limited. Several tiers of opt-out protection could be available to traders of various capitalization and expertise. Contracts might also be restricted to limit orders in order to curb short-term feedback trading.

Election and policy contracts ought to be restricted to domestic accounts only. This will avoid possible extradition problems where disciplinary action is required. In the case of event contracts that may reflect tax rates, this restriction will also determine that the Department of the Treasury will not lose revenue on a net basis. [9]

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[6] The "Stop Trading on Congressional Knowledge Act": http://www.govtrack.us/congress/bill.xpd?bill=h110-2341

[7] Trading prohibitions on insiders will also avoid a situation in which candidates are able to enjoy a multiplier effect on their campaign funds by shorting themselves. For example, Candidate A has a campaign fund of $2, and candidate B has $1. By hedging, candidate A can maintain a $2 risk while spending $4 on campaigning while candidate B can only spend $2 to maintain a $1 risk.

[8] cf. Intrade rules. A more challenging possible scenario involves manipulation preceding the event such that the forced settlement locks-in profits, presumably just as market power is exhausted. See note below on restricting market access to US-based accounts.

[9] Such restrictions would however tend to limit the growth of such markets and/or result in risk premia accruing to short tax-rate positions.

## FLEXIBLE LEGAL IMPLEMENTATION

Instead of, or in addition to, claiming jurisdiction over some event markets, the CFTC has at its disposal a range of public interest exemptions, including some that interpret the 7 U.S.C. § 6(c)3(K) [10] qualification clause liberally in order to include participants who might not normally trade in traditional futures and options markets. From my perspective, such exemptions may allow for a more flexible development of event markets in a less heavily-regulated environment. For example, it might allow for a contract in research science claims where trader-researchers capable of determining the outcome are not readily identifiable, or provide for trading in the sorts of narrow, business-specific questions previously mentioned. From the CFTC's perspective, a public interest exemption may be desirable in order to avoid making a firm jurisdictional claim. However, the outcome of this comment process should be a decisive policy statement from the CFTC, not a sequence of ad-hoc actions. It is hoped that any future public interest exemptions would be offered alongside a substantial list of requirements and guidelines that would at least signal jurisdiction over a class of event markets possessing certain characteristics. Legal certainty is perhaps the most important outcome in this process, and it is not desirable for the CFTC to extend exemptions in a manner that leaves its jurisdiction completely ambiguous with respect to the markets so exempted.

This leaves aside the question of who may operate such markets. If exempted exchanges are to operate for profit, a jurisdictional statement from the CFTC is all the more necessary in order to ensure their legal standing. Exemptions directed at non-profits may be superfluous from a perspective of legal certainty, especially if such exchanges only offer trading in States where the predominant factor test holds.

The CEA allows that public interest exemptions may be issued for specified time periods. The CFTC may wish to consider to what extent exemptive or no-action letters with renew-by dates attached might be a useful tool in light of evolving legal conditions and technologies.

Note that theoretically the CFTC could also assert jurisdiction over all event markets and then direct no-action letters to the finite list of sports and gaming exchanges as a facility to repudiate jurisdiction over such markets. Typically, exempting markets formed principally for speculation would be considered against the public interest. However, if the CFTC finds no satisfactory way under the CEA to take jurisdiction over only those event markets that are associated with economic consequences, no-actioning sports and gaming exchanges would be in the public interest on a net basis, and would best promote interstate commerce. Furthermore, in some cases such exchanges operate under their own regulatory bodies and protections. It is also seldom that such exchanges allow for leveraged trading by beginner participants. In general, most gaming takes place via over-the-counter transactions.

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[10] "Such other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections."

THE PUBLIC INTEREST

I have neglected to argue for event markets in terms of the public interests they promote as these facts have been covered by others and have no doubt been obvious to the CFTC for a long time. I will only note some cases that are more subtle:

Information and estimates can be revealed in conditional form, as in the "decision markets" hosted on Intrade. [11] One such market pays 100% if a Democrat is elected President in 2008 and the national debt rises in the calendar year proceeding October 2011. Since the probability of the former event is also available on Intrade, by $P(A \mid B) = P(A \& B) / P(B)$, we can say that the probability of a Democratic president leading to a rise in the national debt is the decision market price divided by the election market price. This type of market is thus able to predict the result of electoral or legislative decisions, and different decisions can be so compared. With this in mind, consider that while prediction markets are usually described as ways to aggregate information, they are likely also useful in terms of collective problem-solving, even in cases where all information is transparent.

In terms of risk-sharing, eventually the utility of political event markets might begin to address some well-known problems with representative government. Consider the typical special interest problem in which a few relatively well-funded individuals would gain heavily by a particular piece of legislation such as an industry subsidy, and so will lobby heavily for it. Even if the legislation is not in the public interest, the costs will be distributed over so many tax payers that they will not care to argue against it, and most will not even realize what's happening. When mature legislative and public policy markets are in place: (1) the dispersed interests will have the recourse of hedging against policy they dislike, (2) special interests will also have the option of hedging their legislative fortunes, which might lead to an overall reduction in lobbying, and (3) legislators may find compromises to be easier, since interests would be able to voluntarily "meet each other half way," with price being the arbitrator. This could ease political log-jams, making law-making itself more flexible and efficient. Sensible yet otherwise politically infeasible measures such as unwinding entrenched subsidies could be made viable.

Even if iterations are required, the outcome of this comment process should be a clear statutory interpretation and policy statement from the CFTC regarding event markets. The CFTC should also publish self-certification guidelines for those markets that it determines are within its jurisdiction. Once jurisdiction and/or a public interest exemption framework is determined, it should not be ambiguous whether, for example, a contract based on a presidential election would be approved by the CFTC in principle.

There is good deal of apprehension among those who study prediction markets that regulation will stifle innovation. In truth, exchange requirements may not be as onerous

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[11] https://www.intrade.com/index.jsp?request_operation=trade&request_type=action&selConID=565196 For background, see: Robin Hanson, "Decision Markets for Policy Advice," *Promoting the General Welfare: New Perspectives on Government Performance*, pp 151-173, Brookings Institution Press (November 2006).

as they are often portrayed, and in most cases are perfectly appropriate. A related, implied fear is that the CFTC may not approve certain contracts such as those on election and legislative events that undeniably possess economic purpose due only to their political sensitivity and considerations of the CFTC's source of authorization and funding. I hope that this process will assuage such fears. I encourage the CFTC to act decisively and comprehensively in accordance with its purposes.

Sincerely,

Jason Ruspini