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COMMENT

July 2, 2008

Via E-Mail: secretary@cftc.gov

Mr. David Stawick
Secretary of the Commission
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington D.C. 20581

**RE: Response to Request for Public Comment:
Concept Release on the Appropriate Regulatory Treatment of Event Contracts**

Dear Mr. Stawick:

HedgeStreet, Inc. ("HedgeStreet") welcomes the opportunity to comment in response to the "Concept Release on the Appropriate Regulatory Treatment of Event Contracts" ("Release") published by the Commodity Futures Trading Commission (the "CFTC" or the "Commission"). 73 FR 25669 (May 7, 2008). HedgeStreet applauds the Commission in continually taking strides to update and enhance, as necessary, the current regulatory system in order to keep pace with the ever changing marketplace while ensuring market integrity and public trust in the United States' futures and options markets.

Introduction

HedgeStreet is a for-profit corporation organized under the laws of the state of Delaware. HedgeStreet is a fully electronic designated contract market ("DCM") and is registered as a derivatives clearing organization ("DCO") with the Commission. The exchange currently lists daily and weekly Binary Options on various currency pairs, Crude Oil, Gold and Silver. In addition to these current offerings, HedgeStreet previously has listed Binary Options on events such as corporate mergers, hurricanes, corporate earnings-per-share announcements and economic numbers such as Non-Farm Payrolls and Core CPI. The majority of the contracts that HedgeStreet offers or has offered fall within the class of contracts described in the release as "unambiguously subject to CFTC regulation." (Release at 25669 fn. 2) Certain of HedgeStreet's offerings or potential offerings, however, could fall within the category of "event contracts" as described in the release. Accordingly, HedgeStreet has significant interest in the appropriate regulatory treatment of event contracts.

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HedgeStreet's members primarily are retail traders who – because HedgeStreet is a non-intermediated exchange – open accounts directly with HedgeStreet, not with separate clearing members. Moreover, HedgeStreet's contracts are "fully collateralized", so that the exchange and its members do not take on any significant credit risk with respect to the contracts that are traded.[1] HedgeStreet's structure, together with its product offering, provides it with a unique perspective with respect to the issues raised in the Release.

HedgeStreet would like to expand its offering of unique financial instruments to include additional event contracts, such as contracts that have an underlying value based on certain political events, including Election Contracts. Congress made plain in its amendments to the Act in 2000 that it found the national public interest to be served by the regulated futures and option markets is to provide a means for "managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities". (CEA §3(a), 7 U.S.C. §5(a)). That same section of the Act provides that the Act's purpose is to provide

> a system of effective self-regulation of trading facilities, clearing systems, market participants and market professional under the oversight of the Commission ... [and] to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to this Act and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and to promote responsible innovation and fair competition among boards of trade, other markets and market participants.

(CEA §3(b), 7 U.S.C. §5(b)). The Election Contracts that HedgeStreet wishes to offer would be consistent with Congress' finding and in furtherance of the Act's public policy purposes, especially the "promot[ion of] responsible innovation and fair competition among ... markets". *Id.* More specifically, the offer of Election Contracts can be designed to provide risk management value to the public as well as to permit price discovery and dissemination. Furthermore, if traded on a DCM, the Election Contracts can satisfy the Act's applicable Core Principles.

Election Events are "Excluded Commodities" Subject to CFTC Jurisdiction

The Election Contracts that HedgeStreet contemplates offering would be binary options on a commodity. The underlying commodities would be expressed as the occurrence of an event. The event, for example, could be defined as whether the Republican party will win the majority of the United States House of Representatives, Democratic party will win the majority of the United States Senate, or whether a specified candidate or party will win the United States Presidency.

The underlying events for such Election Contracts are commodities for purposes of the Commodity Exchange Act. Indeed, they are well described by the Act's definition of an "excluded commodity", which, as the Commission is well aware, is not itself excluded from the Act's coverage. Instead, such commodity is "excluded" only in the sense that it is eligible to be the underlying commodity for off-exchange contracts between certain

[1] For example, if Member A buys a $100 contract opposite Member B at a price of $60, then Member A pays $60 to the Exchange and Member B pays $40 to the Exchange. If the contract finishes in the money, the contract pays $100 to Member A (his original $60 plus $40 in profit) and Member B loses her $40. (Both members also pay exchange fees to HedgeStreet in connection with this activity.) Our current contract size is limited to $100, but we anticipate listing larger contracts in the near future.

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sophisticated parties that are excluded from the Act.[2] Indeed, exchange-traded futures and options contracts are permitted to be and presently are listed on excluded commodities, such as interest rates, currencies and security indexes.

Section 1a(13) of the Act describes an "excluded commodity", in relevant part, as follows:

> "an occurrence, extent of an occurrence, or contingency... that is (I) beyond the control of the parties to the relevant contract...; and (II) associated with a financial, commercial, or economic consequence."

(CEA § 1a(13), 7 U.S.C. § 1a(13)). Election Contracts meet the requirements of this definition. With respect to the first part of the definition of "excluded commodity", the underlying events for Election Contracts are "occurrences." The strike conditions or payout criteria for the binary options are the occurrences of the election results for the United States House of Representatives, the United States Senate elections, and the United States Presidency, all of which will take place on a specific date.

The nature of the underlying occurrence would be "beyond the control of the parties to the relevant contract" to affect the outcome of the occurrence in each case, in accordance with the second requirement of Section 1a(13) identified above. For example, elections that will determine the President of the United States, as well as control of the House of Representatives and the Senate, are scheduled for November 4, 2008. The Presidential Election involves the registered voters in each state, who vote for a block of electors who, in turn, are pledged to vote for a particular Presidential ticket. These electors actually vote for the presidential candidate. Each state is apportioned a number of electors equal to the total number of their Congressional delegation. Given the number of registered voters in the United States (over 142 million[3]) and the role of the Electoral College in the Presidential election process, it would be impossible for any one person to control the outcome of the Presidential elections. Similarly, given the large number of citizens eligible to vote in the Congressional elections, it would be impossible for any one person to control the outcome of any Congressional elections, let alone the determination of which party would control the House of Representatives or the Senate.

With respect to the final requirements of the definition of "excluded commodity" set forth above, it is self-evident that federal elections have both macroeconomic and microeconomic impacts. Elected officials set fiscal policy and influence monetary policy, thereby affecting US Treasury issuance volumes, US interest rates and the value of the US dollar in the currency markets. The President nominates and the Senate confirms the leadership ranks of the Federal Reserve Board of Governors, the Council of Economic Advisors, all the Departments of the Cabinet and a range of agencies and bureaus collectively overseeing the nation's commercial and economic pursuits. The federal budget on which these elected officials eventually agree allocates vast sums among industries and individuals. Commercial winners and losers are directly created by the decisions of elected officials on the allocation of federal resources among health services, national defense, transportation and agriculture – sectors on which Presidential candidates and political parties routinely stake out competing positions. For example, a shift in national health care policy might be expected to sharply affect the profitability of health insurers, HMO's and pharmaceutical companies which collectively account for a substantial portion of the United States' GDP.

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[2] *See, e.g.*, CEA § 2(d) and (g), 7 U.S.C. § 2(d) and (g).

[3] *Voting and Registration in the Election of November 2004*, Kelly Holder, United States Census Bureau, Issued March 2006.

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Election Contracts, which are in the nature of binary options, would be within the Commission's jurisdiction even if the related event was not a "commodity" for purposes of the Act. Indeed, Congress has given the Commission plenary jurisdiction over exchange traded options, except for options on securities. Section 2(a)(1)(A) of the Act provides the Commission jurisdiction over options on a DCM without regard for whether the underlying is a commodity. That section provides, in pertinent part, as follows:

> The Commission shall have exclusive jurisdiction, except as provided in subparagraphs (C) and (D) of this paragraph and subsections (c) through (i) of this subsection, with respect to … any transaction which is of the character of … an "option" … traded or executed on a contract market designated [pursuant to the Act]. …

(CEA § 2(a)(1)(A), 7 U.S.C. § 2(a)(1)(A)).

<u>Election Contracts and the Potential for Hedging and Risk Management</u>

Since the economic consequences of elections can be so substantial, individuals and businesses have a strong interest in properly anticipating election-day results and, where possible, hedging against adverse outcomes. For example, if a government contractor who participates in government procurement programs can reliably predict the victory of a candidate or a party opposed to those programs, it may use that information to defer or revise its business expansion plans. With the opportunity to evaluate market-based predictions, the contractor may decide to avoid expenditures for business opportunities that will not materialize or shift into other product lines more likely to be valued by the incoming administration. In any case, the accurate election forecast helps the manager to allocate resources and anticipate hiring needs; the information also helps workers in that business make plans for their personal expenditures. Similarly, Election Contracts could give the business and the individual employees a vehicle to hedge the event-specific risks that they face. Critically, the offer of such contracts by a DCM can serve the public policy purposes set forth by the Act while complying with the Act's Core Principles applicable to a DCM.

<u>Election Contracts and the Potential for Manipulation</u>

Core Principle 3 in Section 5(d) of the Act stipulates that a board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation. (CEA § 5(d)(3), 7 U.S.C. § 7(d)(3)). Election Contracts can be designed to meet this Core Principle.

- First, there is no underlying cash market for these contracts. Thus, the Election Contracts will not rely upon any cash price series or cash market trading activity to determine whether a Contract is to be exercised or the amount of the fixed cash settlement payment. That is, there is no underlying cash market to be manipulated.
- Second, as explained above, the outcome of the underlying event – whether Republicans or Democrats win the House, Senate and Presidency on November 4, 2008, – would not be within the control of any person, except perhaps the candidates themselves. Nonetheless, as an added precaution, in addition to the candidates themselves, any individual who may have control or influence over the timing or outcome of the event underlying in any Election Contract could be precluded by exchange rule from trading that contract on the market. This restriction could apply, for example, to members of the Electoral College with respect to trading of Presidential Election Contracts.

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- Third, an independent federal agency, the Federal Election Commission for the Presidential, House and the Senate, will verify the results of the elections. The results will be published on the official outcome of the vote on its website.

DCMs and the CFTC are very familiar with the issue of potential price manipulation and steps to protect against manipulation. The potential for price manipulation is no reason to preclude the offering of Election Contracts by a DCM; to the contrary, that potential argues in favor of requiring these types of contracts to trade in the regulated markets with appropriate controls and oversight.

The Commission Should Regulate Election and Other Event Contracts

The Act clearly provides that event markets are subject to CFTC regulatory jurisdiction. As discussed above, in view of the Act's public policy purposes and the manifest commercial and financial interest in electoral outcomes, it is appropriate that the CFTC exercise that jurisdiction with respect to Election Contracts and other political event markets. These markets already exist, but in imperfect forms. Currently, these markets exist in at least three forms:

- First, the CFTC has, through exemptive authority, granted relief to the Iowa Electronic Markets ("IEM") to operate an election market. As noted in the Release and a number of academic studies (Release at 25670 & fn 6), the IEM has demonstrated the superior predictive power of a financial derivatives market in political contracts. The IEM, however, has strict limits on contract value ($1.00), participation (a maximum of 2,000 traders) and position size (a maximum of $500 risk in any particular market). The IEM's limited pool of participation arguably limits the opportunity for information aggregation and, though still better than ordinary polls, the accuracy of its predictive power. In addition, the limitations on the size the contract value and amount of risk exposure a market participant can acquire essentially render moot any meaningful hedging value in this market.

- Second, a host of "free" prediction markets exist throughout the United States. (See, e.g., CNN Political Market, http://politicalmarket.cnn.com; and WSJ Political Market, http://predictions.wsj.com/#). These markets lack the price discovery incentives of a true financial market like a DCM or even the IEM, offer no hedging value and are not subject to regulatory oversight or other protections that would enhance the integrity of such markets.

- Finally, one of the most popular Election Markets concerning the United States' political process is operated by a business incorporated in Ireland, Intrade, at http://www.intrade.com. Intrade's market is restricted with respect to participation by United States residents. Despite these limitations, trading information from these markets – and, in particular, Intrade's current Presidential Election contracts – is broadly disseminated to the United States voting public and other U.S.-based users. (See, "About Intrade", http://www.intrade.com/ (June 5, 2008) ("we have supplied market data to CNBC, CNN, FOX, WSJ, FT, New York Times, 7 Federal Reserve Districts, over 50 major universities and graduate schools in the US, the ECB, Cato, Bank of Japan, Bank of England, presidential candidates and major and boutique Wall Street firms.") Despite the broad dissemination of Intrade's market data to United States citizens and the obvious national interest in its election market data, this for-profit market is not subject to any regulation comparable to the regulatory regime for DCMs. According to Intrade's website:

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> "Intrade is not a recognised or designated investment exchange as defined by the Financial Services Act 1986 of the UK, the Stock Exchange Act, 1995 of Ireland or the Central Bank Act, 1989 of Ireland nor an investment business firm as defined by the Investment Intermediaries Act, 1995 of Ireland. Trading contracts on-line on the Intrade exchange involves risk. ...
>
> Intrade is neither a bookmaker nor does it hold itself out to be a bookmaker under Irish or UK law."

"About Intrade", http://www.intrade.com/ (June 5, 2008). Accordingly, Intrade would assert that the Core Principles that protect the integrity of United States futures markets, including the principles prohibiting manipulation, do not apply to this market.

Each of the existing market models falls short of potential benefits to the public of an Election Market operated as a DCM.

DCMs Should Be Permitted to Operate Election Markets

The CFTC's recognition of the ability of DCMs such as HedgeStreet to offer Election Markets would fulfill Congress' mandate "to promote responsible innovation and fair competition among boards of trade[and] other markets." (CEA §3(b), 7 U.S.C. §5(b)). DCMs are well-suited to operate effective, efficient Election Markets. As described above, DCMs by definition have the capacity and experience to self-regulate their markets with CFTC oversight. This regulatory regime mandates, among other things, that DCMs protect against manipulation of their markets (Core Principle 3), have the capacity and structure to ensure the financial integrity of their contracts (Core Principle 11) and protect market participants from abusive practices by their agents (Core Principle 12). Compliance with these and the other Core Principles that govern DCMs will, in the context of Election Contracts, provide a market for the public that is both widely available and reliable.

Moreover, in order for these markets to operate efficiently and serve the public interest, they should be available to all suitable investors. Alternative markets, such as an Exempt Board of Trade ("EBOT") or a Derivatives Transaction Execution Facility ("DTEF") are not open to all market participants and are subject to lesser (or, in the case of EBOTs, virtually no) regulatory oversight. To be most beneficial, Election Markets should not be limited to a small class of high-net-worth investors such as Eligible Commercial Participants or be required to transact business through, and pay requisite brokerage fees to, large futures commission merchants. Any such mandated barriers to entry into the market would significantly limit the ability of the market to aggregate all relevant information. The HedgeStreet model provides the protections of a DCM structure and without the same burdensome expenses of the traditional intermediated DCM market. Accordingly, the CFTC should not limit – and should, in fact, recognize – the ability of DCMs such as HedgeStreet to offer Election Markets.

Conclusion

The public interest in Commission regulated Election Markets is manifest. The CFTC has been authorized under the Act to regulate such an event market. The market structures currently in place in the United States do not sufficiently meet the need for or interest in Election Markets. Therefore, the CFTC should act to permit Designated Contract Markets in the United States to offer Election Contracts to the public. In order for these markets to operate efficiently, they should be available to all suitable investors among the general public, not just to a select few high-

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net-worth investors. Finally, these markets should operate in conformity with the Core Principles applicable to all Designated Contract Markets and must be able to demonstrate this ability to the satisfaction of the Commission.

Should you have any questions regarding the above, please do not hesitate to contact me by telephone at (312) 884-0171 or by email at tmcdermott@hedgestreet.com.

Sincerely,

Timothy G. McDermott
General Counsel and Chief Compliance Officer

CC: Ed Dasso – NFA
Yossi Beinart – HedgeStreet, Inc.

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