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secretary

From: Chris Masse [cfm@midasoracle.com]
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To: secretary
Subject: Concept Release on the Appropriate Regulatory Treatment of Event Contracts

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Commodity Futures Trading Commission
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Attention:
Office of the Secretariat- secretary@cftc.gov

COMMENT

Reference:
Concept Release on the Appropriate Regulatory Treatment of Event Contracts
73 FR 25669

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Just a technical note, before I give you my thoughts. In the following, I call "prediction market" the specific market where one particular event derivative is traded. (For instance, the "Barack Obama will be elected US President in November 2008" prediction market.) And I call "prediction exchange" the general marketplace where many prediction markets (on political elections and other events) are traded. (Hence, I call HedgeStreet a "prediction exchange").

Please, allow me to give you my thoughts on the subject of real-money prediction exchanges:

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ABOUT THE INFORMATION AGGREGATION MECHANISM, FORECASTING, THE LIQUIDITY OF THE SOCIALLY VALUABLE PREDICTION MARKETS, THE DEVELOPMENT OF A US-BASED PREDICTION MARKET INDUSTRY, AND THE PROTECTION OF RETAIL TRADERS

The information aggregation mechanism functions well only if there are enough traders. Probabilistic predictions (which are of interest of the economists cited in the CFTC's concept release) are generated only when there is enough liquidity, that is, when many traders come speculating on an event derivative market (e.g., on the topic of the next political election). Just because forecasters are interested in a topic and want to generate a market-based probabilistic prediction does not mean that traders will flock en masse. Market-generating forecasting is an offspring of the trading activity; if you have too little liquidity, you don't have any trustworthy probabilistic prediction.

The socially valuable prediction markets should meet 3 criteria:
- their contracts should be very well drafted, so that the probabilistic predictions generated would be useful to society;
- a sufficient number of traders should like the topic;
- there should exist advanced, primary indicators which traders can follow to get early information (e.g., polls, among other sources of information, in the case of prediction markets on political elections).

Here's a counter example. Yahoo! Research scientist David Pennock (one of the most active and well regarded researchers in this field) has created a set of prediction markets regarding the percentage share of web searches made in the US in 2008, for each Internet

search engine (Google, Yahoo!, etc.) That would be extremely valuable, on the paper. Unfortunately, those sets of prediction markets have attracted only a fistful of traders:
http://www.intrade.com/aav2/trading/tradingHTML.jsp?evID=78364&eventSelect=78364&updateList=true&showExpired=false
Hence, no trustworthy probabilistic predictions were generated.

The CFTC should take with a grain of salt the 2008 petition organized by the American Enterprise Institute
http://www.reg-markets.org/publications/abstract.php?pid=1276
that states that "not-for-profit research institutions" and "government agencies" should be allowed to run US-based, real-money prediction exchanges, for the good of society. Just because an oganization is smart and fascinated by the prediction markets does not mean that its executives and managers will be capable of drawing traders. Obviously, prediction exchanges should be run by trading specialists and event derivative professionals, and properly regulated. No good will be done by the CFTC if amateurs are allowed to run un-regulated, real-money prediction exchanges.

I see 2 important keys for the development of socially valuable prediction markets.

a) The socially valuable prediction markets (which are not very popular, other than the ones on political elections) should be organized by the generalist prediction exchanges that draw traders en masse because they offer prediction markets on very popular topics.

Sports is a popular topic. If the CFTC go to the website of TradeSports http://www.tradesports.com/ , they will see that TradeSports links, on its frontpage, to the InTrade prediction markets at http://www.intrade.com/ and, thus, send the TradeSports traders to the InTrade prediction markets, which is obviously good for InTrade's liquidity in general, and especially good for InTrade's socially valuable prediction markets. In the same manner, the prediction markets on political elections organized by BetFair UK http://www.betfair.com/ are located within their central prediction exchange that is mainly devoted to sports.

The hard fact is that the most popular topic among individual traders (the retail customers of the prediction exchanges) is sports. As long as US laws and regulations won't allow US-based, real-money prediction exchanges to organize prediction markets on the topic of sports, many US event derivative traders will give their business to offshore, real-money prediction exchanges who accept to take money from US residents (as it is the case with TradeSports-InTrade Ireland).

I understand, though, that the CFTC is working under a jurisdiction that presently outlaws prediction markets on sports.

b) The executives of the popular, real-money prediction exchanges should be willing to create socially valuable prediction markets by collaborating with outside researchers who specialize in certain verticals.

As of today, InTrade is the only real-money prediction exchanges that fill these 2 criteria ---a) and b). InTrade's executives and managers have deployed a considerable effort to create and run an impressive number of socially valuable prediction markets.

BetFair UK have chosen not to develop socially valuable prediction markets, alas ---other than those on UK politics, which are well developed and of high social utility. And HedgeStreet does not have yet the CFTC's stamp of approval to run markets of event derivatives non-financial topics, since that's the purpose of the May 2008's concept release.

The economists Justin Wolfers, Eric Zitzewitz, Robin Hanson, Koleman Strumpf and David Pennock (among others) have collaborated with InTrade Ireland to frame interesting questions. Obviously, the research institutions which those economic scientists are affiliated with (e.g., universities, colleges, business schools) have no business running real-money prediction markets.

If the "not-for-profit research institutions" and "government agencies" want to develop socially prediction markets, then they should do it in cooperation with established, popular, regulated, real-money prediction exchanges, who know what they are doing.

(In passing, I fully support Tom W. Bell's point made in the 5th paragraph of his petition. The CFTC should not favor the not-for-profit prediction exchanges at the expense of the for-profit prediction exchanges. Tom W. Bell's comment to the CFTC has not yet appeared on the CFTC website, as I type this.
http://agoraphilia.blogspot.com/2008/07/lets-tell-cftc-where-to-go.html)

As I said, I follow the prediction market industry since 2003, and the 2 most common mistakes I see made by the people proposing brand-new socially valuable prediction markets are that:
- they forget that the event derivative traders should have fun;
- they forget that, for each prediction market, there should exist advanced, primary indicators that traders should rely on to inform their trades.

I want to tell the CFTC that most people who talk about creating brand-new socially valuable prediction markets are totally unaware of these 2 basic rules.

In the beginning of this comment, I said that prediction markets are forecasting tools (and, hence, decision-support tools) if, and only if, there is sufficient liquidity. I also noticed that the world's most liquid socially valuable prediction markets are offered by 2 exchanges (TradeSports-InTrade and BetFair) who use popular prediction markets (on sports, the fact is) to support the marketing of less popular, socially valuable prediction markets. (After making that argument, I acknowledged that the CFTC currently works for a legal environment that prohibits prediction markets on sports.)

My point here is to emphasize the uber importance of liquidity on socially valuable prediction markets. In my view, the best situation is when a big, generalist, real-money prediction exchange organize socially valuable prediction markets and helps them to thrive. Only InTrade Ireland has done that, so far. My suggestion to the CFTC would be create a legal environment such that their liquidity could be "repatriated" to the US, on a "InTrade USA" real-money prediction exchange.

A related issue is that the CFTC should be concerned about HedgeStreet's financial health. After its third round of funding, HedgeStreet raised a total of $24.9 million.

http://www.hedgestreet.com/abouthedgestreet/pressreleases/pressrelease_21.html

Lately, HedgeStreet was aquired by an offshore investor for $6 million.

http://www.hedgestreet.com/abouthedgestreet/pressreleases/pressrelease_32.html

Obviously, there has been destruction of wealth, here.

The CFTC did a great job in 2004 when it approved HedgeStreet's application as a Designated Contract Maker (DCM). The CFTC should now finish the job by creating a legal environment favoring the profitability of HedgeStreet and of other non-intermediated DCMs (e.g., InTrade USA, or BetFair USA, or TradeFair USA) ---which I hope will be started up in the future in the US.

What I am afraid with the May 2008's concept release on "event markets"
is that the CFTC does not look into the real issues: the liquidity of socially valuable prediction markets, and the profitability of US-based companies operating real-money prediction exchanges (non-intermediated DCMs).

I'm afraid that all these solutions consisting in "exemptions" and "no-action" letters are false solutions that do not address the real issues.

Finally, for the issue regarding the protection of retail traders, I suggest that the CFTC looks into the worst scandal that occurred in the field of prediction markets ---the "North Korea Missile prediction market" scandal. I am sad to say that InTrade Ireland acted in the worst way possible, and, thus, have indelibly tarnished their reputation, alas.

http://www.midasoracle.org/predictions/nkm-scandal/

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Thanks for listening,

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