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COMMENT

7 July 2008

Commodities Future Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Eurasia Group comment to the CFTC regarding:
Concept Release on the Appropriate Regulatory Treatment of Event Contracts
Federal Register Release: 73 FR 25669
May 7, 2008 (Volume 73, Number 89)
Pages 25669-25674

To whom it may concern,

Eurasia Group is a global leader in political risk analysis. We have many financial, corporate, and government clients across the US, Europe and the developing world. At these organizations, we support the work of analysts, traders, portfolio managers, project leaders, risk officers, and corporate executives. They employ us both on a retainer basis and for custom project work to explain and forecast political, social, and security developments around the world.

Our financial clients (including, but not limited to, US and UK-based global macro and multi-strategy hedge funds, emerging markets investors, commodities funds, investment banks and private equity funds) are active in global equity, debt, currency, and commodity markets, and also make critical use of derivatives. Our corporate clients (including, but not limited to, multi-national companies concentrating in the extractive, automotive, retail and consumer product industries) invest and operate around the world, in both developed and developing nations. All these clients face a wide range of real world circumstances. They are familiar with a range of risks, including operational risk, market risk, credit risk, and counterparty risk. They come to us for a better understanding of political risk; these may be local (labor strikes and social unrest), national (an unfriendly government or harmful regulatory changes), regional (military conflict or public health crises) or international (terrorism, treaty arrangements or sanctions). Any of these risks can materialize to do real harm to investors and companies.

For those concerned with political risks, there are two main challenges: assessing the likelihood of a risk materializing and developing mitigation strategies. For other types of risk, investors and operators have sophisticated assessment techniques, including value-at-risk models, detailed financial statement analysis, and the hard-earned experience of senior managers. And for other types of risk, there are a range of risk management tools, including internal controls, financial hedging, and insurance. But the assessment and mitigation strategies available for political risk are relatively paltry.

Political risk analysis properly done is a rigorous process that provides valuable predictive insight. And yet political risks remain among the most badly measured of all risks. In part, this is because analysts bring a wide range of biases to political risk work. Ideology, hope, and fear are manifest in much political risk analysis. In addition, a thorough analysis of political risks often requires an understanding of a wide range of facts, and skills in a wide range of disciplines. Few people or organizations can bring all these resources together to perform a comprehensive assessment.

Even when political risks are properly measured, there remains the problem of mitigation. For market participants, political developments can mean financial losses even when the investor has gotten the economics of the investment right. And for corporations, politics can do serious damage to company operations, even when the business model is otherwise solid. But investors who know markets and businessmen who know commerce have a very hard time coping with this sort of problem. Many times, the only apparent way to avoid the political risk is to forego the opportunity. But an investment not-made or a factory not-built represents a real loss – both to the investor and to the people who would have benefitted from the commitment of resources. Those wanting to hedge political risk can, in some circumstances, purchase over-the-counter insurance against a particular event. But these private contracts are done on a one-off basis, do not have very competitive or rigorous pricing, and are illiquid. For example, if the relevant risk becomes evidently less after such an insurance contract is bought, the buyer's only recourse may be to sell the contract back to the insurer, almost certainly at a terrible price. This dynamic discourages the use of political risk insurance products.

Active and public event markets could be very useful for addressing the challenges of political risk assessment and mitigation. Our clients, who may become very active in event markets, are not interested in creating artificial zero-sum contracts to engage in risk-taking that is distinct from their primary investment goals. Instead, they are interested in event contracts for risk assessment and mitigation.

Regarding assessment, the price discovery function of markets would be invaluable to aggregating the collective knowledge and judgment of investors, companies and observers on questions of political risk. As demonstrated by the history of limited event markets like IEM and Intrade, the implied forecasts generated by event market trading are among the most accurate public predictions of political developments available anywhere. The information conveyed by event market pricing is useful even to those who do not trade in these markets, and provides a valuable input to financial, corporate, and government decision-making.

An event market could also function as a valuable mitigation tool. As with all derivative markets, an event market is fundamentally a mechanism for reallocating risk. Investors and companies who want to hedge against a particular political development could do so in an event market, with a tradable contract designed specifically around the particular event. And as the level of risk associated with a specific political development changes over time (and the contract prices changes accordingly) market participants will be able to adjust their positions to maintain the desired level of risk protection. On the other side of the hedging trade will be market participants (including perhaps some insurers) who have the willingness and resources to take on the additional risk.

The net result will be to provide more accurate public assessments of political risks around the world, and a mitigation tool for investors and companies who want to operate in politically risky environments in a prudential manner. This is an unmitigated public good.

Sincerely,

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