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EVENT MARKET TRANSACTIONS ARE NOT GAMBLING:
A COMMENT IN RESPONSE TO THE CFTC'S CONCEPT RELEASE ON THE APPROPRIATE REGULATORY TREATMENT OF EVENT CONTRACTS

by

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COMMENT

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I. Introduction

A. *Definitions*

For purposes of this Memorandum the following definitions apply:

Act means the Commodities Exchange Act codified as Title 7, Chapter 1 of the United States Code.

Commission means the Commodities Futures Trading Commission.

B. *Background*

The potential societal value of Event Markets is so well established in both theory and practice that it is no longer open to serious question. However, a principal concern of some commentators is the perception of a disquieting similarity between Event Markets and traditional forms of gambling such as sports betting and lotteries.

While the public policy merits of anti-gambling laws continue to generate spirited debate, there is little doubt that for the foreseeable future such laws will remain in effect in the United States at both the state and federal level. Event Markets will never realize their promise if their legality under these statutes remains in doubt.

It seems clear that the Commission has the regulatory authority to preempt the application of state gambling laws to Event Markets. However, absent a rational basis for distinguishing between Event Markets and gambling, it will be difficult to justify exercising this power.

Thus, in considering how Event Markets should be regulated, the threshold question is: are Event Markets simply another type of gambling within the meaning of anti-gambling laws? This is the question addressed by this Comment.

II. The Legal Definition of Gambling

Laws that regulate or prohibit gambling commonly define "gambling" to be any activity that includes three elements: a wager, for a prize, where the outcome is determined by chance. For example, New York State's penal code defines gambling as follows[2]:

> *A person engages in gambling when he stakes or risks 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.*

Read literally this standard three element test for defining gambling encompasses activities most people would agree are unlike traditional forms of gambling such as casino games, lotteries and the like. For example, the net economic benefit from buying insurance or trading commodities or securities may owe more to chance than the sagacity or skill of the purchaser/trader. Yet few policy makers would want to treat such activities as "gambling" in a legal sense. For this reason, statutes prohibiting or regulating gambling often specifically exclude from their application such activities.

III. Event Markets Under the Three Element Definition of Gambling

Event Market transactions include each of the three elements of gambling under the traditional legal definition: the contract price, the chance for a monetary payout, and gain or loss determined by the uncertain outcome of a future event. However, Event Markets are a recent innovation and known by a relatively small community consisting largely of experts and academics. It is not surprising that gambling laws – most of which were adopted many years ago – do not carve out Event Markets from the legal definition of gambling.

IV. How Event Markets Differ From Gambling

"Chance" by its nature requires reference to a future event whose outcome cannot be known with certainty. Most gambling activities rely on future events that are *contrived*, *trivial* and *immediate*. That is, a gambling event is (i) created and conducted by the game organizer rather than a product of nature or independent human activity; (ii) without independent social or economic significance; and (iii) short-lived, with an outcome known within a very short time (usually a few minutes or even seconds).

Casino games (including card games such as poker and black jack, dice games such as craps, wheel games such as roulette, and mechanical games such as keno and slots) all share these characteristics. Most lotteries also have these three characteristics, but the initial time horizon is usually a few days rather than a few minutes.

In contrast, Event Market transactions involve future events that are *independent*, *significant* and *long-lived*. Governmental election results, weather events, a nation's possible resort to military action or the dividend to be paid by Microsoft are typical of the future events underlying Event Market contracts. These events occur (or not) independently of both the contract market and the contract parties. These events have consequences far beyond the economic gain or loss of the contract parties - they impact thousands or millions of people. Finally, these events usually have initial time horizons of weeks, months or years. These differences between Event Market transactions and gambling are significant in two ways.

First, Event Markets perform the socially useful function of information aggregation. Event Markets do this because Event Market contracts (i) are based upon real-world events that are independent of both the Event Market operators and the contract participants and have social or economic significance, and (ii) have a longer time horizon that facilitates the discovery of hidden but valuable information about the underlying event will be discovered.

By contrast, the primary reason why most people gamble is for entertainment. Gambling's contrived events (the roll of the dice, the turn of the card, the spin of the roulette wheel) yield only the most trivial information. There is nothing of social or economic value to discover and aggregate. But for the entertainment value of roulette or craps, no one would care what number resulted from a spin of the wheel or a roll of the dice. Similarly, gambling events have a short time horizon because that tends to increase the volume of gambling by (a) increasing its entertainment value, and (b) increasing the number of events upon which wagers can be made within a given time period.

Second, gambling's contrived, trivial and short-lived nature increase the risk that it will lead to an increase in the addictive, compulsive or other abusive gambling pathologies (and their attendant negative social effects) which are the impetus for most anti-gambling laws. The atmosphere created by gambling operators (e.g., bright lights of the "strip", the idealization of the "high roller" persona, and the appeal to the adoption of an "anything goes" attitude ("what happens in Vegas stays in Vegas"), is designed to heighten the excitement and adrenalin rush that encourages larger and more frequent betting.

By contrast, Event Market participants are much less likely to suffer from these behavioral pathologies. Event Market contracts focus on real-world events of intellectual interest to the contract participants. With time horizons of months or years, Event Market contracts are hardly vehicles of immediate gratification. Thus, while investing in Event Market contracts may provide some entertainment value, it is far removed from the celebration of excess that is the hallmark of the gambling industry. The aspects of gambling that hold the greatest risk for encouraging abusive behavior is quite remote from the Event Market industry. A contract on the possibility of a hurricane landfall in South Carolina is unlikely to generate day dreams of James Bond at the baccarat table.

VI. Event Markets and Sports Gambling

Professional sporting events occupy a gray area in distinguishing between gambling and Event Markets. The Super Bowl is not contrived by a gambling operator like roulette at a casino. Further, the game is arguably non-trivial since its outcome does in fact affect large numbers of people and can have significant economic consequences. Finally, Super Bowl winner contracts could be offered many months in advance of the event. Consequently, it is not unreasonable to argue that at least some contracts on sporting events should also be exempt from gambling laws.

However, a key difference between sporting events and events like political elections and weather forecasts is that sporting event outcomes are far more susceptible to corrupt influence because a single individual (whether a player or a referee) may have the power to affect an outcome. This fact alone is sufficient reason to prohibit as a matter of prudence and public policy trading in sporting event contracts.[3]

Sports related trading that does not carry the risk of promoting corruption should probably be permitted. Thus, the corruption exception would not seem to be applicable to sports related contracts that are not tied to individual games, tournaments or seasons (e.g., will Barry Bonds be inducted into the Hall of Fame during his first year of eligibility) and should be permitted.

VII. Conclusion

Event Markets are concerned with future events of social or economic significance that are outside the control of the Event Market operators and participants. The contracts traded on Event Markets have time horizons of sufficient length to allow the discovery of hidden information related to such events. Event Markets appeal to intellectual interests rather than emotions and entertainment. These differences imbue Event Markets with a societal utility that is missing from gambling and justifies very different legal treatment.

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[2] New York State Consolidated Code; Penal Section 225

[3] As the Commission has already stated, similar prohibitions may be adopted for public policy reasons, e.g., event contracts on the possibility of political assassinations.