Commissioner Bart Chilton
Dissent

from

Approval of Media Derivatives Exchange's Opening Weekend Motion Picture Revenue Futures and Binary Option Contracts

June 14, 2010

I respectfully dissent from the Commission's action today to approve Media Derivatives Exchange's (MDEX) Opening Weekend Motion Picture Revenue Futures and Binary Option Contracts on the motion picture *Takers*, submitted pursuant to Section 5c(c)(2) of the Commodity Exchange Act (CEA or Act) and Commission Regulation 40.3.

Relevant Provisions of Commodity Exchange Act and Regulations

Section 5c(c)(2) allows for prior approval of new contracts, and CEA Section 5c(c)(3) provides that the Commission "shall approve any such new contract . . . unless the Commission finds that the new contract . . . would violate this Act."

Section 2(a)(1)(A) of the CEA states that the Commission has exclusive jurisdiction over transactions "involving contracts of sale of a commodity for future delivery." Section 3(a) further provides that transactions subject to the CEA are invested with a "national public interest by providing a means for managing and assuming price risks . . . ." Accordingly, pursuant to these two sections, in order for the Commission to exercise jurisdiction over a transaction, the Act requires that such a transaction involve an underlying "commodity," and that the transaction provide a means for "managing and assuming price risks . . . ."

In addition, Commission Regulation 40.3(d) "*Notice of non-approval*," states that, should the Commission determine not to approve a new contract, it notify the requestor and further provides that, "[t]his notification will briefly specify the nature of the issues raised and the specific provision of the Act or regulations, including the form or content requirements of paragraph (a) of this section, that the product would violate, appears to violate or the violation of which cannot be ascertained from the submission." Section 40.3(a)(4) requires that the

submission "[c]omply with the requirements of Appendix A to this part—Guideline No. 1" Guideline 1 is classified as an non-exclusive "acceptable practice" to satisfy the requirements of one of the contract market designation criteria—Core Principle 3, CEA Section 5(d)(3)—relating to non-susceptibility to manipulation. Appendix A—Guideline 1 includes three provisions, (a)(4), (b)(4), and (c)(4), providing that the submission shall include "such additional evidence, information or data relating to whether the contract meets, initially or on a continuing basis, any of the specific requirements of the Act . . . ."

Accordingly, in order to disapprove a request for prior approval pursuant to Section 5c(c)(2), the Commission must base that decision on a violation of the CEA. In the instant case, I believe such violation exists, and on that basis I dissent.

Analysis

Section 2(a)(1)(A)—Is there a "Commodity?"

The Commission's rationale for its action today is explained in a "Statement for the Commission" appended to the MDEX approval letter. This explanation, concluding that motion picture revenue contracts involve an underlying commodity, is fundamentally flawed. In the first instance, the Commission relies on the broad definition of "commodity" in CEA Section 1a(4)—"all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in"—to provide statutory authority for determining the existence of a commodity. The Commission indicates that Congress intended to broadly define "commodity." Absolutely correct. There is a limit, however, to the elasticity of the definition.

In interpreting the CEA, we are to exercise some modicum of common sense in determining whether or not there is a public interest in deeming some "thing" a commodity for purposes of federal on-exchange derivatives regulation. Otherwise, the statute is meaningless; unless some sensible judgment is exercised, we could approve terrorism contracts, or contracts on whether a certain movie star will die or become disabled, or contracts on the likelihood of UFOs hitting the White House. Each of these events could have economic consequences, but it is hardly appropriate under the Act to deem them "commodities." To say that, simply because one can develop a futures contract, the underlying is a "commodity" is circular reasoning, at best. Using this analysis, anything under the sun could be a commodity if you could, at some time in the future, have a futures contract on it. We know that is not how Congress intended for us to interpret the Act.

In this instance, the Commission has not provided any sufficient rationale as to why judgment should be exercised to expand the broad definition in Section 1a(4) to include "motion picture revenues." In its "Statement," the Commission makes the conclusory statement that "movie futures fall into the same category as many other commodities for which futures and options contracts have been either approved by or self-certified to the Commission where the underlying commodity in a non-price-based measure of an economic activity, commercial activity or environment event." The Commission further goes on to list other "similar" types of contracts. Unfortunately, simple assertion does not make it so. The precise issue—that of fundamental jurisdiction—is simply not adequately addressed by the Commission. Specifically,

there is no sufficient legal analysis to support the bare assertion that, in this case of first impression, movie box office revenues are "commodities" under the CEA. There is only the assertion that "we've done this before, these look like other futures we've seen before." That simply isn't good enough, particularly when we have so much evidence that movie box office revenues are not "what we've seen before."

In the alternative, if the broad definition will not suffice, the Commission turns to the definition of "excluded commodity," section 1a(13), inserted in the Act as part of the Commodity Futures Modernization Act of 2000 (CFMA). This definition does not mean that such a commodity is "excluded" from regulation; it simply means that it is eligible for exclusions that were included in the CFMA. Again, there is negligible legal analysis provided with regard to this provision; perhaps there is a reason for that, inasmuch as none of the sections are applicable. Motion picture revenue contracts are not "occurrence[s]" as contemplated in Section 1a(13)(iv), because the transactions are not "beyond the control of the parties to the relevant contract, agreement, or transaction," as required by subsection (I). Nor are they measures of economic or commercial risk, return or value, as provided in Section 1a(13)(ii), because there arguably is a cash market in this contract (the sale of tickets to the public that determines the price of box office revenues), in contraindication to subsection (I).

There are two other points worthy of note. It is somewhat mystifying as to why the Commission focuses on whether there is a "requirement" for the existence of a cash market in order to have a futures contract. Obviously, there are numerous futures contracts for which there is no underlying cash market. This issue becomes important in analyzing, for example, Section 1a(13)(ii), which includes that issue specifically in statutory text. The Commission, however, seems to misapprehend the focus of the concerns surrounding movie box office futures, as if whether or not a cash market exists is a requirement for is developing a futures contract. That is not the case. That requirement is, as noted, an issue in a particular statutory text, and is important in its analysis. It is not a *sine qua non* of approving a futures contract. Second, it is noteworthy that the Commission, in its "Statement," indicates "[t]he term 'event' contract has no meaning under the Act." Indeed. It is precisely this issue that we should be analyzing. In May 2008, the Commission issued a concept release to attempt to elicit public comment on the issue of what types of "events" fall under the penumbra of the Commission's jurisdiction. It would have been helpful to have more fully developed these legal issues prior to the issuance of today's approval. Instead, the Commission has, by this action, simply made the virtually unadorned assertion that "these are commodities," and approved the contracts. I do not believe that is sufficient under the CEA, nor do I believe it is an exercise of good judgment.

Accordingly, if there is no clear applicable definition of "commodity" into which we can fit movie box office returns, there is a fundamental jurisdictional obstacle to approving the requested contracts.

As provided in Regulation 40.3(d), there is a burden on the requestor to show that the transactions meet the requirements of the Act, including the requirement of Section 2(a)(1)(A) that the contract be based upon a "commodity." In this instance, the requestor has not provided evidence to ensure that the proposed contracts do not violate this Section. Nor can the Commission determine from the evidence submitted (or from the comments received) that the

proposed contracts do not appear to violated this Section. Lastly, the Commission has not received sufficient evidence from the requestor (or from comments received) to ascertain whether the proposed contracts violate this Section.

Section 3(a)—Does the Proposed Contract Involve "Managing and Assuming Price Risks?"

The Commission has focused largely on whether or not the proposed contracts will be "susceptible to manipulation," and on the adequacy and sufficiency of Rentrak numbers. In addition, while the CFMA deleted the economic purpose test from the Act, such analysis has been used by the Commission in its approval of these contracts. While these efforts are laudable, they miss the mark. It does not appear, unfortunately, that any of the analysis undertaken adequately addresses the fundamental purposes of Section 3 of the Act.

Specifically, in utilizing the economic purpose test, there has been focus on whether 1) participants in the industry face price risks (or attendant risks) in their business operations, and 2) the proposed contracts generally relate to those risks. The key point, however—whether there is evidence that the contract can actually be used to manage those risks—has regrettably been avoided.

Given the conflicting information received on this point, and the inherent conflicts that a single producer/single "commodity" contract presents, the Commission has not provided sufficient basis to approve this contract as a viable hedging tool. This is an action of first impression at the Commission—the first time that it has approved a contract where there is a single producer, a single entity controlling the entirety of the "market." The fact that conflict of interest rules were necessary points out the fundamental flaw in reasoning of the approval: if it is necessary to "wall off" the primary (or at least, one of the primary) users of the contract, how can it be deemed a viable transaction used to "manage" risk? In addition, while we have heard testimony that movie investors "may" be able to use such contracts, this testimony is rebutted by other evidence and testimony that the contract design is fundamentally flawed, both in timing and in scope. Accordingly, the information received by the Commission—in this unique case before it—is equivocal at best. Moving forward on such slim evidence is not, in my opinion, either warranted or wise.

As provided in Regulation 40.3(d), there is a burden on the requestor to show that the transactions meet the requirements of the Act, including the requirement of Section 3 (a) that the contract provide a "means for managing and assuming price risks . . . ." In this instance, the requestor has not provided evidence to ensure that the proposed contract does not violate this Section. Nor can the Commission determine from the evidence submitted (or from the comments received) that the proposed contracts does not appear to violate this Section. Lastly, the Commission has not received sufficient evidence from the requestor (or from comments received) to ascertain whether the proposed contract violates this Section.

Conclusion

On the basis of the foregoing, I respectfully dissent from the Commission's approval of MDEX's motion picture revenue contracts. It is my hope and expectation that, in the future, the Commission will perform a more fulsome and careful review of such submissions.

6-14-10

Bart Chilton