

**Media Derivatives, Inc.**  
**Responses to the MPAA March 23, 2010 Letter to the CFTC**

Media Derivatives, Inc. (“MDEX”) is submitting this paper in support of our pending DCM application that was delayed by product related questions by the Motion Picture Association of America, Inc.’s (“MPAA”) on March 23, 2010. The public comment period on the MDEX DCM application ended on November 5<sup>th</sup>, 2009 (nearly 5 months ago); the public comment period on the MDEX proposed products, which may have impact on some of the constituents of the MPAA, ends on April 8<sup>th</sup>, 2010. MDEX values the concerns raised by the MPAA and wishes to point out that none of the issues are new to the MDEX product structure or to the MDEX market model; in fact, all of the issues have been fully vetted with the CFTC and addressed in the 100 plus documents that have been submitted by MDEX in support its DCM application. (See the Index of Documents Chronology previously submitted.) Upon learning about the product related concerns raised by the MPAA on March 24<sup>th</sup>, MDEX suggested an extension of the 180-day statutory deadline of our pending application as a DCM to April 2, 2010 so as demonstrate the MDEX compliance with the CFTC processes and commitment to the Core Principles of the Commodities Exchange Act. MDEX believes that based on the thorough and detailed review of the CFTC staff with regard to the MDEX DCM application, that the April 2<sup>nd</sup>, 2010 extension allows ample time for approval of the pending application. MDEX recognizes that CFTC staff has determined that MDEX meets the designation criteria and core principles to be approved as a DCM; and, accordingly, has recommended to the Commissioners that the application be approved. MDEX further recognizes that the issues raised by the MPAA relate to a pending product application that was submitted on March 4<sup>th</sup> and is currently available for public comment through April 8<sup>th</sup>, 2010.

MDEX wishes to point out that it holds the MPAA in high esteem as the association responsible for reviewing and rating movies. Furthermore, MDEX contract listing rules for its initial, proposed product offering (currently in public comment period), require an appropriate MPAA rating as criteria for listing a movie on its market. MDEX, in September 2009 and in connection with its submission of its application for approval as a DCM, pro-actively agreed with CFTC staff in submitting its proposed Opening Weekend Box Office Motion Picture Revenue Contracts for CFTC review and public comment rather than requesting the opportunity to self-certify. MDEX acknowledges, and has abided by, this agreement as a condition for approval as a DCM. For the aforementioned reasons, MDEX does not believe that the pending status of its DCM application should be further delayed. As has been demonstrated throughout the DCM application and review process, the MDEX staff will be responsive to any issues and concerns, such as those expressed by MPAA, that are raised during the product approval process.

*MPAA Issue #1*

*MPAA questions whether the DCM applications should be approved because they appear to be inextricably tied to movie futures contracts that may be inherently vulnerable to price manipulation.*

The MPAA concerns are product based. Concerns regarding the products should not delay approval of the MDEX DCM application. The MPAA’s statement that the DCM application should not be approved as it is tied to movie futures contracts is inaccurate; but, should be applied to the pending product approval which is currently available for public comment. While MDEX intends its first product offering to be based on opening weekend movie box office revenues, the exchange is developing a wide range of media-

related products as hedging tools to be offered over the next couple of years. The DCM application should be addressed and approved based on the exchange's ability to comply with CEA designation criteria and core principles for a DCM. Upon demonstrating that MDEX has met those requirements, the CFTC staff had recommended the MDEX DCM to the Commission for final approval. The Opening Weekend Box Office Motion Picture Revenue Contracts should be considered on their individual merits and are currently open for public comment. A letter received from a trade organization nearly 5 months after the procedural public comment period should not cause delay to the MDEX DCM application. We do agree that the concerns raised by the MPAA while valid, have already been addressed by MDEX throughout its documentation in its DCM and Product applications. Accordingly, MDEX will demonstrate its attention to the issues raised by MPAA through referring to the respective documents presented within its applications that has been thoroughly reviewed by the CFTC staff.

*MPAA Issue #2*

*Even if the DCM applications are approved, MPAA requests the Commission not approve for trading the movie futures contracts themselves. MPAA understands some futures contracts are submitted for CFTC approval and some futures contracts may be self-certified by a DCM as complying with the CEA. The CFTC's web-site does not reveal which avenue has been pursued by CFEX or MDEX. MPAA urges the CFTC not to allow any movie futures contracts to be listed for trading unless the CFTC grants prior approval of the terms and conditions of such contract. Self-certification by the DCM should not be available for contracts that raise important public policy issues.*

At the time MDEX filed its formal submission in September 2009 and more currently in the March 3, 2010 Representation Letter, MDEX committed to submitting its product rules and contract specifications for the Opening Weekend Motion Picture Revenue Contracts for CFTC approval. On March 4, 2009, MDEX submitted its rules and contract specifications for listing binary options and collared futures on Opening Weekend Box Office Motion Picture Revenue contracts for approval. At the CFTC's request, MDEX followed up on March 9, 2010 with the submission of the terms for contracts on a specific movie, *Takers*, also for formal approval. MDEX has remained diligent in maintaining contact with the CFTC Staff to address all questions and to ensure they have all the information required to approve the products. Furthermore, MDEX has worked closely with several of the MPAA constituents with regard to the proposed product offering. The initial product offering is currently posted for public comment. MDEX agrees with the MPAA that any exchange requesting approval for, or attempting to self-certify an opening weekend movie based product, be subject to the same formal review process as agreed upon and is currently in process between the staff of MDEX and CFTC.

*MPAA Issue #3*

*Maintaining the reputation and integrity of the movie business is of critical importance to the MPAA and its members. In our view and based on the materials available in the public record, the reputation and integrity of our industry could be tarnished by allowing trading in the movie futures contracts in a manner which allows them to be viewed as the economic equivalent of legalized gambling on movie receipts. We can see no public purpose in allowing these contracts to be the subject of interstate commerce.*

MDEX fully agrees that the reputation and integrity of the movie business is of critical importance, not only to the MPAA and its members, but also to MDEX, the CFTC and all market participants. The

MDEX market structure has been designed to address the needs of the movie industry, not the retail public. We have adopted a traditional, FCM intermediated model that has contracted with an established DCO to provide clearing services that include risk management structure and a conservative margining methodology similar to those employed by the largest CFTC-regulated clearing house. We have contracted with the NFA, an established regulatory services provider and futures industry SRO, to supplement our market surveillance and supervision requirements. These market structure measures have been undertaken at substantial costs to insure the highest levels of market integrity, transparency, counterparty protections, contract standardization, and regulation for all participants.

The products have been designed to service the risk management needs of the movie industry, specifically to hedge post production performance, and not to provide, as some have stated, a means to “gamble” on the box office success of any movie. In early discussions back in June 2009, the staffs of CFTC and MDEX discussed concerns for box office revenue products developed with a retail level perspective. While not intending to create a retail-focused market, MDEX took the CFTC’s perspective to heart in developing its products. As a result, MDEX proposed products have a notional value of \$5,000 per contract which is well beyond the value of other publicly touted box office revenue products. In addition, the products have stipulated trading/price ranges that protect market participants’ exposure. Recognizing that some movie industry sectors may not have much, if any, experience with futures markets, MDEX wanted to ensure that the products offered would enable them to establish appropriate risk mitigation hedge portfolios where the absolute exposures were known at the time of trade execution.

MDEX does not believe that a comprehensive, centrally cleared, institutionally structured and well regulated exchange would contribute to reputational risk. The MPAA’s claims of reputation risk may be more appropriately directed towards entities such as the Hollywood Stock Exchange (HSX) which currently trades such products or Intrade, which operates an active contract-for-difference (CFD) market for such products, which is devoid of any regulation. Rather than operate in an opaque foreign or OTC type market, **MDEX seeks to develop transparency onto the products while allowing such products to be traded in the U.S. under a comprehensive regulatory structure.**

*MPAA Issue #4*

*In addition, MPAA and its members fear that it will be untenable for our members and related parties such as movie theatres, banks, financial investors, producers, advertising partners, research companies, members of the public who view test screenings and all others involved to ensure compliance with the kinds of safeguards that may be necessary in light of these contracts.*

*And*

*MPAA Issue # 5*

*Many parties may possess such material non-public information and it will be virtually impossible for the exchanges, the Commission or the studios to enforce compliance.*

The CFTC staff raised similar concerns regarding possible insider influence on compiling the public box office figures in order to affect final settlement prices for MDEX products and possible actions the studio/distributor might take on the use of a movie's advertising budget to influence daily pricing of the contracts. MDEX has satisfied these concerns through product design and various processes and procedures. Along the lines of product design, the products are short-term contracts that are only listed for trading four weeks in advance of a movie's release. Four weeks prior to a movie's release, the market has a great deal of public information at its disposal to render trading decisions, and marketing plans are well into the execution phase. Secondly, MDEX rules require that the opening weekend revenue products cease trading prior to a movie's release in theaters thus, removing the concern regarding the earlier availability of box office information to the studio/distributor than the public.

A key aspect of product integrity addressed by the CFTC and MDEX is the determination of the box office revenue figure used in establishing the products' expiration prices. In meetings that MDEX has held with major studios, sensitivity to public expectations for box office revenues accuracy and reliability were expressed to MDEX. In support of this studio position, MDEX presented information and developed rules and processes to ensure the integrity of its expiration prices.

1. MDEX provided information regarding AICPA Statement of Position 00-2 "Accounting by Producers or Distributors of Films". (See "Responses to CFTC Questions Regarding Contract Design Issues", July 15, 2009)
2. MDEX further expounded upon this aspect by submitting a letter from Media Finance Structures, LLC on December 11, 2009 addressing studio/distributor record retention for theater box office receipts.
3. MDEX developed the "Motion Revenue Contracts Box Office Revenues Validation and Verification Processes". We collaborated with the CFTC in developing these key processes and procedures. Highlights of these processes include:
  - a. Ensuring the studio/distributor publicly reported box office number fit within a pre-set standard deviation derived from data provided by the industry leading data provider that collects box office revenue information directly from the theaters;
  - b. Maintaining up to date studio/distributor and theater data for all wide-release movies and using the data to periodically adjust the standard deviation;
  - c. Requiring the studio/distributor to provide evidence to support its public box office number when it falls outside the standard deviation level;
  - d. MDEX will determine an appropriate box office level, using theater and studio/distributor data, in which to establish the final expiration prices, when the studio/distributor cannot justify its box office number; and
  - e. Weekly verification of the process for collecting theater box office data.

MDEX was able to develop these critical processes as a result of contracting with the industry leading data provider, at a significant cost, to receive the raw box office data acquired directly from the theaters.

4. MDEX adopted Firewall and Restricted Participant Review rules and procedures.
  - a. Communication is prohibited between the individuals responsible for or having input into the studio/distributor's decisions to trade such Contracts (the "trading group"), on the one hand, and its employees who are responsible for compiling and/or

computing the gross box office revenues publicly disseminated by such studio/distributor for its motion pictures regarding the studio/distributor's positions in any such Contracts or the trading group's decisions or discussions with respect to establishment of such positions. The disclosure prohibition on these employees also extends to disclosing the information to any other parties, except as necessary, in performance of the employee's responsibilities.

- b. Certain employees within a studio/distributor and companies that collect box office revenues are prohibited from trading MDEX box office products.
- c. Studios/distributors that participate in MDEX markets are required to adopt procedures to monitor the communications and enforce the trading prohibitions.
- d. MDEX will periodically review the studio/distributor procedures and require them to attest that the procedures are included in internal control reviews.
- e. MDEX will routinely review a studio's/distributor's expired movie contracts for patterns between expiration prices and positions to determine if there may be issues with firewall procedures.
- f. When a party applies to the exchange for trading access, MDEX will require the party and his clearing firm to identify whether he may be subject to trading restrictions under the MDEX rules.

By no means is it expected that any constituent of the MPAA be required to participate on the proposed MDEX DCM. MDEX has been designed as a solution for the various risk takers throughout the entertainment industry. Various participants may be involved in utilizing various products (pending) of MDEX if such participants desire to participate, are qualified to participate, follow the required process to become a participant and follow the rules that have been put in place to protect the integrity of the market. MDEX understands that various constituents of the MPAA may choose not to participate in some or all of the proposed products and that participation will require an extended period of education with regard to the structure and use of any approved products as well as the rules and regulations governing the proposed DCM. The same applies to the greater universe of potential market participants beyond the constituents of the MPAA.

*MPAA Issue #6*

*Moreover, neither of the movie futures contracts would seem to serve the congressionally-defined public interests in futures trading in CEA §3(a): As the Commission itself has observed, "[c]ustomarily, hedging and price basing have been identified as the two critical functions of the commodity derivative markets." 73 Fed. Reg. 25669, 25672 (May 7, 2008). In terms of hedging, the DBOR contract will bar virtually all hedging contrary to claims we understand CFEX to have made. By rule, major studios will be prohibited from hedging their financial risk in a particular movie because they possess material non-public information about the movies they fund and produce (see CFEX DBOR Rule IV-12(a)2).*

MDEX products were designed for an institutional market structure focused on providing risk mitigation and hedging for the entire movie industry; including studios, producers, commercial banks, film-finance funds, theaters and talent agencies. While the MPAA is submitting comments on behalf of its membership, the value of the MDEX model and products reaches well beyond the MPAA membership.

Additionally, MDEX has met extensively with a number of these parties including some of the producers and distributors identified as MPAA members in footnote 1 of the MPAA's letter. These parties are supporters of the MDEX market structure and product concepts. The operational and compliance processes and procedures identified above have been favorably received by these parties. As stated previously, these potential hedgers recognize the vital importance of establishing and maintaining market integrity on all aspects.

MDEX has explained and evidenced its market and product structures to the CFTC. Our documentation clearly presents that the movie industry has a number of risks associated with the development, production, promotion and distribution of its product that warrant the need for risk mitigation tools that have been absent in the industry and can be met by MDEX products. Any entity intending to offer futures products to serve the movie industry should have to justify the products' commercial viability and benefits and should also present the structures that will be adopted to ensure market integrity.

The MPAA comments regarding CFEX DBOR contracts should be addressed by parties familiar with them. However, based on information available on the CFTC website pertaining to CFEX, the MDEX proposed products (which are currently available for public comment) differ significantly from CFEX' product offering. Furthermore, MDEX has never discussed its proposed products in any public forum or with the media as our focus has been on approval of our DCM and working closely with identified potential market participants. It is our understanding that the MPAA raised concern with regard to not having been contacted by either proposed exchange with regard to the DCM application process. MDEX was advised that such discussions should be held at the time of public comment on the products given the potential conflict of interest with Mr. Dan Glickman head of the MPAA (now stepping down as of April 1<sup>st</sup>, 2010) who serves on the board of a potential competitor, the CME. Furthermore, given the extensive relationships of MDEX within the entertainment industry, product design and initial discussions were held with not only many of the constituents of the MPAA but with a much larger group of participants. The business decision made by MDEX was to assure protection of its shareholders with regard to the company as the company consists of many well respected individuals within the entertainment industry. We trust that the MPAA can understand the nature of our concern with regard to risk associated to our DCM status- such issues of potential conflict were recently raised in the national media. The MDEX business decision was out of protection for all parties. Subsequently, MDEX has initiated discussions with MPAA regarding our product submission and the recent concerns regarding such products.

*MPAA Issue #7*

*In terms of price basing, it is unrealistic that any commercial transactions will be based on the exchange-published prices for a movie's potential box office prospects. In fact, MPAA is not aware of any commercial transactions that are today based on the weekly movie box office totals that are published and widely-quoted in the media.*

MDEX disagrees that the primary purpose of exchange traded products is to provide pricing basis for commercial transactions. The financial purpose of a futures market for a hedger is for risk transference. Is every futures trade in corn, Treasuries, currencies and energy markets intended solely to provide pricing information for other commercial transactions? A trade meets the immediate needs of the participants. One party has an exposure which he desires to mitigate and the other party is willing to

accept the risk for reasonable price. The trade is not done with the intention of serving any other party's commercial needs. Commercial and institutional participants will use MDEX products to hedge with the goal of reducing the financial exposure on an underperforming asset which in the market would be opening weekend box office revenues.

Studios/distributors, producers, theaters and others have a need to generate a stipulated return on a specific asset, the movie. Each industry segment has different risks and exposures to the opening weekend box office revenue levels. In the "Economic Analysis: Motion Picture Risk Transfer Contracts" dated August 2009, the importance of the opening weekend is addressed.

"Even though a theater screens a movie for six to eight weeks, the first week accounts for approximately forty percent of the box office revenues of the average picture. More importantly with more movies coming to market, there is increased competition for screen exposure. The opening weekend sets the tone and the perception for the financial success of the movie going forward and secures screen space to elongate its run. The conventional thinking is that if you gave a movie a big enough push out of the gate, its momentum would keep it going. A big opening weekend could start what economists call a "non-informative information cascade," where people would go to the movie simply because everyone else was going too. The idea is to take a concept, add a hefty marketing budget and a wide release to give it momentum, and studios can create a self-fulfilling hit. Unfortunately, several extraneous factors that can influence revenues such as the weather, or unexpectedly hard competition, making the timing of the opening weekend difficult to manage."

The paper also addresses the box office risk to other industry parties. Note- according to the MPAA, the average cost of production, promotion and advertising of an MPAA rated film in 2007 exceeded \$107million. Such films often take in excess of 2 years of development and involve a waterfall of financial participants. All such participants look in anticipation of opening weekend as such generally accounts for approximately 40% of the projected revenue. The risks leading up to opening weekend have mechanisms to offer protection. What the MPAA and their constituents cannot control is how the public receives the film and/or what events may affect a movies' opening debut (catastrophic events such as the world trade center bombing, to climate events such as severe snow storms, etc..). The commonly used mechanism for risk management on opening weekend is a waterfall of financial participants that share financial risk in an OTC type structure. The current economy has forced many of those participants to remove or dramatically reduce their participation in film financing to the likes that many renowned producers are now seeking capital from foreign countries in order to continue producing movies. In summary: two years or more of production, average cost in 2007 of over 107 million, significantly increasing costs expected with the increasing demand for 3D (of which production quadrupled in 2009), declining sales in DVD, increased piracy of content, increased public opinion from social media sites affecting viewer decision to watch the movies, increased movie competition – particularly from the rapidly growing independent film market, and one weekend opening that accounts for nearly 40% of the revenue. These are some of the reasons that MDEX has proposed an opening weekend product for its initial product utilized on its DCM and reflect many of reasons why various constituents of the MPAA, with whom we've been working, as well as many of the participants in the greater universe of contributors to film financing have been supportive of the MDEX premise.

Simply stated, MDEX through its design and professional participants offers a tool to the entertainment industry. This tool is not a retail-focused product and therefore does not contribute too many of the issues that the MPAA has raised. MDEX agrees that there are considerable concerns on any retail focused product as such does not truly resolve the legitimate needs of the entertainment industry. MDEX, in our conversation with MPAA, will be all means encourage open dialogue about the currently proposed MDEX product offering and other products that may be of benefit to constituents of the MPAA.

*MPAA Issue #8*

*Instead of serving any commercial purpose, movie futures will simply allow the public to bet on whether a movie will be successful at the box office. MPAA submits that unbridled gambling, no matter how clothed, is not in the public interest which Congress found to be served by futures trading regulated under the CEA. MPAA respectfully requests the Commission not allow movie futures contracts to be traded unless or until a DCM can demonstrate that the hedging or price basing purposes of its movie futures contract.*

MDEX is unsure of the intended statement provided above as the MPAA did not complete its statement of objection to the contracts' approval making it difficult for MDEX to know the specific aspects of hedging or price basing to be demonstrated. If the MPAA is asking an exchange to demonstrate that its contracts will serve the purpose of hedging or price discovery, MDEX has demonstrated that its Opening Weekend contracts are designed to meet significant risk management needs of the motion picture industry. In the end, though, the only way to get a definitive answer is for the CFTC to allow the market to open so that the marketplace can determine the risk management value of the contracts. MDEX has met all the requirements for DCM approval; CFTC Staff has completed its review; the application has been submitted to the Commissioners with Staff's recommendation for approval. MDEX products have been discussed extensively with the CFTC Staff; the products have been submitted for approval; and the CFTC has posted the product submission for public comment.

Once the DCM application is approved on its merits and the products separately approved, the market will determine the value of the product offering. The market, as it always has, will decide whether the contracts meet their intended purpose. Similar objections have historically been raised on many new product concepts with the products approval being based on the economic justifications. The same objections were raised at the 11th hour concerning both Treasury futures and stock index futures by entities with even more direct connection and concern about the impact of new markets on their entrenched business models. All objections fell to the wayside as the CFTC did what they should have done; left it up to the market to determine the "value" or "purpose" of the new products. While the MPAA's questions are valid and raise appropriate product related questions, a delay in the approval of the DCM application is not believed to be warranted. The issues raised by the MPAA have been thoroughly acknowledged and addressed throughout the MDEX applications.

*MPAA Issue #9*

*MPAA respectfully requests that the Commission, at a minimum, seek public comment on these issues by publishing the terms and conditions of the movie contracts in the Federal Register. Opening these issues*



*up to transparent public comment is the least the Commission could, and should, do under the circumstances.*

MDEX had committed to submit its Opening Weekend Box Office Motion Picture Revenue Contracts and did so on March 4, 2010. We have continued to work with CFTC Staff regarding the product submission. MDEX supports the MPAA's position to seek public comment on its movie contracts, as the CFTC has initiated with its recent posting of our product submission on its website requesting comment by April 8, 2010. However, the issues raised by the MPAA should not warrant further delay of the MDEX DCM application.

#### Conclusion

MDEX is of the opinion that the MPAA's letter is not applicable to the MDEX DCM application. The CFTC Staff has completed a diligent review of the MDEX DCM application. This is evidenced by the Staff's recommendation to the Commissioners that the MDEX DCM application be approved. MDEX requests that the CFTC resume its DCM review process and acquire the Commissioners' approval of its DCM application in an expedited manner.

The MPAA's letter addressing issues relating to movie products should be taken into consideration in the CFTC's approval process for MDEX' Opening Weekend Box Office Motion Picture Revenue Contracts.