May 26, 2010

<u>Via Hand Delivery</u>

David Stawick, Secretary
Office of the Secretariat
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Applications of Media Derivatives, Inc. and Cantor Futures Exchange L.P., for Approval of Contracts on Motion Picture Box Office Receipts

Dear Mr. Stawick:

The Directors Guild of America, Inc. ("DGA"), the Independent Film & Television Alliance ("IFTA"), the International Alliance of Theatrical Stage Employees ("IATSE"), the Motion Picture Association of America, Inc., and its member companies, Paramount Pictures Corporation, Sony Pictures Entertainment Inc., Twentieth Century Fox Film Corporation, Universal City Studios LLLP, Walt Disney Studios Motion Pictures, and Warner Bros. Entertainment Inc., and the National Association of Theatre Owners ("NATO") – collectively, the motion picture industry – respectfully file this additional comment in opposition to the proposed collared futures contract and binary option contract of Media Derivatives Exchange, Inc. ("MDEX") on estimated opening weekend motion picture revenues for the motion picture *Takers*, and the futures contract of the Cantor Futures Exchange L.P. ("Cantor") on the estimated domestic box office receipts for the motion picture *The Expendables* (collectively, the "Contracts").

We submit this letter to address certain points raised during the Commission's open meeting on May 19, 2010.

A. Insider Trading Issues

Commissioner O'Malia asked that we provide additional comments with respect to the difficulty in policing the use of "insider information" in the event that the proposed Contracts are approved. Cantor's Organization Rule VI-12, as approved by the Commission on April 20, 2010 and now published on the Commission's website, and its pending DBOR Contract Specification II-18(a) broadly proscribe "any person" from trading when in possession of material non-public information:

> "[A]ny person in possession of any material non-public information regarding the commodity underlying such Contract is prohibited from trading in such Contracts until such information has been disseminated in a manner that makes it generally available or accessible to the public, through the news media, the Internet or otherwise."

Commission Rule 1.59(a)(5), 17 C.F.R. § 1.59(a)(5), defines "material information" to mean information which "where publicly known, would be considered important by a reasonable person in deciding whether to trade a particular commodity interest on a contract."

Attempting to establish objective and clear criteria as to the information a reasonable person would find important in attempting to predict the entertainment appeal of a motion picture is exceedingly difficult, if not impossible, because a reasonable person's prediction will involve, at least in part, inherently subjective judgments about artistic merit and public interest. For example, using the Commission's definition, would a reasonable person deciding on a particular bet on domestic box office receipts for a unique motion picture consider the following information to be important: (a) audience reaction to private screenings before the release of the film, (b) accounts from production insiders that a star actor was suffering from alcohol abuse and struggling to stay attentive during filming, (c) non-public information that a script needed to be rewritten near the end of production because a particular star became ill and could not finish the filming as originally conceived, or (d) the opinion of one studio executive stated in a confidential communication that the cinematography was "exceptionally good"?

The Cantor representative at the May 19, 2010 public meeting before the Commission testified that Cantor's Rules do not treat information about the artistic or entertainment quality of a motion picture as being material non-public information. Nothing in Cantor's Organizational Rules or its DBOR Contract Specifications, however, so provides. The broad concept of materiality in the Commission's Rule calls such testimony into question. Cantor's approved Organization Rule VI-12 and its pending DBOR Contract Specification II-18(a) state only that material non-public information includes "but is not limited to" the following: "(i) changes in the scheduled release date of the relevant film; (ii) the actual number of theaters in which the film will be shown; (iii) changes in the promotion or advertising budgets of a film; and (iv) actual box office receipt statistics once a film has been released."

Further, determining when information is "public" is exceedingly difficult in the motion picture industry. Commission Rule 1.59(a)(6), 17 C.F.R. § 1.59(a)(6), defines "non-public information" to mean information "which has not been disseminated in a manner which makes it generally available to the trading public." Rumors, which if true would constitute material information, might circulate in some quarters within the motion picture industry, but that would not necessarily render the information "public" under the Commission's definition, Cantor Organization Rule VI-12 or its pending Contract Specification II-18(a). When a rumor could be considered to render non-public information "public" is, at best, a difficult and uncertain factual and legal determination, subject to significant after-the-fact second-guessing.

Although MDEX's Rules do not expressly bar trading on all material non-public information, its Rules are broad enough to apply such a proscription. MDEX Organizational Rules 511 and 514 prohibit fraud, dishonorable or dishonest conduct, conduct inconsistent with just and equitable principles of trade, and violation of the Commodity Exchange Act ("CEA"). MDEX's Rules 906 and 907 require a firewall between individuals responsible for or having input into the studio/distributor's decisions to trade MDEX's Contracts, 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 and prohibit trading by such persons.

The burden on studios and any organization or natural person that invests in or is otherwise involved in the production of a motion picture to determine when information is both "material" and "non-public" and to police against its use is immense. Cantor's Organizational Rule VI-12 and Contract Specification II-18(b) expressly require that entities that participate in trading in Cantor's DBOR Contracts "shall adopt policies and procedures adequately designed to ensure that its officers, directors, employees and agents, including its Authorized Traders, do not trade on the basis of material non-public information in violation of" Cantor's Rules and Contract Specifications.

Even if studios and other organizations that would be privy to material non-public information do not trade in the contracts, they might feel compelled to adopt and police anti-insider trading procedures in order to prevent employees, officers and agents from activity adverse to the interests of the organization and to try to better insulate themselves from any potential derivative liability for any insider trading by them. Under legal norms for insider trading proscriptions under the federal securities laws, an organization can be held to possess the material non-public information known to, at a minimum, its senior officers and directors. In this situation, many lower level employees have access to box office receipts statistics for all motion pictures reported to Rentrak Theatrical, Inc. ("Rentrak") as a tool used in the performance of their jobs, not for any investment purpose. Attempting to police the use of that information by not only each employee, but that person's range of acquaintances would be practically impossible for distributors (including studios), exhibitors, and those who work for the companies that gather such information.

As explained in our prior letters dated April 8 and 16, 2010, and May 11 and 18, 2010, knowledge about a motion picture may be closely guarded, but the number of persons who possess knowledge about a motion picture is very substantial. Attempting to police the activities of all persons who may be hired to work on a motion picture together with their agents and other representatives, who all are in varying degrees privy to material non-public information connected not only with the picture prior to its release but also concerning its grossing performance thereafter, would be extremely difficult at best. As Scott Harbinson who testified on behalf of the IATSE and DGA made clear at the open meeting on May 19, the vast majority of persons who work on a motion picture are independent contractors. Thus, hundreds of contracts may be required to be modified or renegotiated to address the new obligations that could be thrust upon the motion picture industry if the Contracts are approved.

These concerns underscore another point that we have made repeatedly. Given the breadth of the prohibition on insider trading, it is difficult to conceive that any person with an investment or other involvement with a motion picture would not possess material non-public information. They, accordingly, would not be permitted to trade – and therefore to use the Cantor or MDEX Contracts for hedging. None of the witnesses who testified in support of the Contracts even addressed this dilemma.

B. Slate Financing and Other Investments in Motion Pictures Do Not Involve "Shorting" Motion Pictures

Witnesses who testified in support of the Contracts mischaracterized the various types of investments in motion pictures to be the equivalent of the studios "shorting" their own motion picture. The various opportunities studios and others offer for investment in a motion picture involve diversifying the investment risk in motion pictures. They do not involve in any way betting against the success of the picture as entering into a short futures contract or selling an option would. None of the investment opportunities offer an ability to profit from poor box office performance.

C. Manipulation Concerns Are Not Limited to the Integrity of Rentrak's Methodology

The Staff's testimony regarding manipulation seemed to focus on the question of whether Rentrak accurately and reliably compiles and publishes estimates of box office receipts. That issue is clearly material to the question of whether a settlement price could be manipulated, but it does not address the additional concerns with manipulation of futures and options prices prior to a motion picture's release. Those prices cannot be compared to any other prices or economic data to determine their economic integrity. Accordingly, even determining when such prices would be deemed "manipulated" is an uncertain exercise. It is noteworthy that the Staff explained that the legitimacy of futures pricing based on third-party indices, such as Standard & Poor's Real Estate Price Index, is typically determined by reference to the entire "cash price series" of the index. The proposed Contracts, however, have no cash price series. They concern an estimate related to a single event.

Also, as we have stated previously, the grossing ability of a motion picture can be manipulated through decisions that could be made unilaterally by any distributor or a large exhibition circuit such as, for example, changing release dates (which creates a different group of competing pictures in the marketplace at the same time); increasing or reducing the number of runs for the picture domestically; deciding whether a film will continue to be exhibited at various theaters, and, if so, in which auditoriums (the number of seats varies per auditorium); and changing its advertising and publicity campaign. Attached hereto as Attachment A is a compilation of the views of law professors and others, as published on the Internet, that highlight these concerns and others.

D. Variation in Rentrak Numbers

Witnesses for the Exchanges implied that the Rentrak number is highly accurate because it is based on Rentrak's receipt of box office data through electronic transmissions from exhibitors. While the electronic data itself, although not error free, could be considered to be reasonably accurate, the extent of the viewership it captures from one motion picture to another can be materially different. A trader betting on box office receipts would want to know whether the settlement price will be calculated on the basis of electronic data from 96% of the exhibitors as opposed to, for example, 84% of the exhibitors. It might be thought that, if Rentrak for a particular motion picture is capturing only 84% of the marketplace, the ultimate estimated number is subject to a greater margin of error than if Rentrak's compilation covers 96% of the exhibitors. The percent of reporting exhibitors, however, is not known and cannot be known in advance of a motion picture's release and, in any event, is not disclosed to the public. This material variation in the Rentrak data presents an unacceptably high arbitrariness for betting on the box office receipts of any particular motion picture.

E. Definition of Commodity

The preliminary response of the Staff at the May 19, 2010 hearing regarding whether a box office receipt or the estimated number of box office receipts provided by Rentrak is a "commodity" should be reconsidered. We respectfully submit that the only definition of a "commodity" that permits the subject of an event contract to be a "commodity" under the CEA is the definition of "excluded commodity" in CEA § 1a(13). An event does not fit within the definition of "commodity" in CEA § 1a(4) because an event is not a good, article, right, service or interest. For the reasons set forth in our letters to the Commission dated May 11 and 18, 2010, the box office receipts and the estimated numbers of them do not fit within the definition of "excluded commodity."

F. The Contracts Are Not Designed for Hedging

Each Contract is a separate bet on a particular level of box office receipts. With legitimate futures contracts, a hedger is effectively agnostic to futures price increases or decreases, because the profit or loss on the futures contract will offset the profit or loss on the hedger's commercial risk in a cash market. The proposed Contracts do not function in that way. They simply allow a trader to make a separate bet on a particular level of box office receipts, and it is possible for a trader to both lose on its futures or options contracts and on any investment impacted by box office receipts.[1]

G. There Is No Over-the-Counter Trading in Box Office Receipts

At the May 19, 2010, public meeting, Chairman Gensler asked industry witnesses whether they were aware of any over-the-counter ("OTC") derivatives dealing with box office receipts. All of the responses were in the negative. This is very telling, because the most appropriate time for a financier to hedge its risks would be when it commits to financing a motion picture or a slate of pictures, not months or years later when a picture is about to open. If there were a viable and workable OTC hedging mechanism, it would be logical that the witnesses at the May 19 meeting would have been aware of it, but none were. Given the legal certainty created by the passage of the Commodity Futures Modernization Act in 2000 for OTC products, it is reasonable to believe that the sophisticated investment banks and other financiers of the motion picture industry would have developed OTC trading products to hedge their risks if there were a real market for them that would not violate federal and state anti-gambling laws. This underscores the fact that the proposed Contracts are designed to capture the interest of retail bettors on the Hollywood Stock Exchange ("HSX"). As Cantor declares on its website:

> **"If you know HSX, then you already know how Cantor Exchange works. * * * Now, with Cantor Exchange, you can do what you love to do - trade on box office revenues - for real money!"**

http://www.cantorexchange.com/Market-Overview/Info-for-HSX-Traders.aspx (emphasis in original).

H. Pending Financial Reform Legislation

As the Commission is aware, Section 721(a)(4) of the Senate version of H.R. 4173, the Restoring American Financial Stability Act of 2010, amends the CEA to exclude motion picture box office receipts from the definition of "commodity." If this provision becomes law, the Contracts would not be lawful under the CEA. This creates substantial legal uncertainty with respect to the Contracts. Because it appears that Congress may likely pass final legislation before July 1, 2010, in the event the Commission were to approve the Contracts, it would not be in the public interest for the Commission to permit such Contracts to trade for a short period before they become unlawful, if the Senate provision were to be enacted into law. We believe the National Futures Association, which both has responsibilities as a self-regulatory organization for the regulation of futures commission merchants ("FCMs") and private contractual obligations to MDEX and Cantor to assure legal compliance in any trading of the Contracts on those exchanges, would have an interest in preventing any foreseeable market crisis and unnecessary trading losses

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[1] Estimated box office receipts have very limited commercial use in the motion picture industry. Generally, contractual obligations in the industry are tied to actual receipts, not estimates, except for instances involving certain contracts with talent which might create bonus compensation if the estimated box office receipts reach an agreed to target level. As the testimony of Scott Harbinson on behalf of IATSE and DGA made clear, the memberships of those organizations, which cover motion picture talent, are opposed to the Contracts.

and legal liability for traders and FCMs if the Contracts suddenly became unlawful and unenforceable. In these circumstances, in the event the Commission were to approve the Contracts, it should exercise its authority to preclude any trading in any Contract on motion picture box office receipts until the issues presented by the pending legislation are resolved.

The Coalition, again, thanks the Commission for the opportunity to provide its views.

Sincerely,

Jay D. Roth,
National Executive Director
Directors Guild of America, Inc.

A. Robert Pisano,
Interim Chief Executive Officer
Motion Picture Association of America, Inc.

Matthew D. Loeb,
International President
International Alliance of Theatrical Stage Employees

Jean M. Prewitt,
President and Chief Executive Officer
Independent Film & Television Alliance

John Fithian,
President and Chief Executive Officer
National Association of Theatre Owners

cc: Chairman Gary Gensler
Commissioner Michael Dunn
Commissioner Scott O'Malia
Commissioner Jill Sommers
Commissioner Bart Chilton
Mr. Richard Shilts
Thomas Leahy, Jr.

ATTACHMENT A

Professors Raising Issues with Box Office Futures

http://motherjones.com/politics/2010/02/subprime-goes-hollywood
Subprime Goes Hollywood
The Wall Street wizards who gave you credit default swaps want to turn the movie industry into their next casino.
By Nick Baumann | Fri Feb. 12, 2010 4:03 AM PST

If you thought the mortgage-backed securities and other complex financial instruments that crashed the economy were risky, you'll love Wall Street's latest brainwave: a new financial market in which players can gamble on whether upcoming Hollywood movies will be blockbusters or bombs.

For years, Cantor Fitzgerald, a Wall Street investment firm, has been operating the "Hollywood Stock Exchange [1]," a fake-money game in which players trade "stocks" to bet on how films will do at the box office. Now Cantor could soon get government permission to make a real-money version of the game—a market in which players can gamble on the success or failure of, say, Pirates of the Caribbean 4 [2]. Critics are worried that this new market could be vulnerable to insider trading and create bizarre incentives for moviemakers—and that it will also enlarge the risky family of financial products that helped trigger the economic crisis.

"This is such a bad idea on so many levels," says **Lynn Stout** [3], a law professor at UCLA and an expert in derivatives, the category of financial instruments that includes Cantor's proposed box office futures. "What they want to do is basically open up a casino for people who want to make money for predicting the next blockbuster."

Here's how it would work. Hollywood studios, actors, directors, investment banks, hedge funds, and anyone else would be able to buy and sell contracts based on the value of all ticket sales in the first four weeks of a movie's release. According to Cantor Fitzgerald's plans, the contracts would each be worth one-millionth of a given movie's gross sales during that four-week period. Let's say that you thought Avatar would pull in $500 million during its first four weeks. So, you buy 100 futures contracts at $490, figuring that when Avatar made $500 million you'd be up $1,000. Unfortunately, as it turned out, Avatar "only" made some $430 million domestically [4] in the first month after its release—meaning that you'd lose a cool six grand.

One problem, skeptics say, is that Hollywood insiders could have a huge advantage in such a market. People in the movie business often have far greater access to crucial information about a film's box office prospects than ordinary investors do—such as how big the marketing budget will be or how bad the performances are. "If the industry is selling, odds are that it is a bad idea to buy," says Dean Baker, the codirector of the Center for Economic and Policy Research.

Another problem, says **Stout**, the law professor, is that such a market creates "all sorts of perverse incentives to manipulate the success of movies." Let's say you were responsible for Gigli, and you realized during filming that it was shaping up to be one of the worst movies ever made [5]. Instead of writing off the $54 million you'd shelled out to make the film, you could simply buy up a stack of futures contracts priced on the assumption that the movie would tank. Then, to nudge that failure along, you could slash the marketing budget, or decide to add 30 more dreadful minutes to the final cut. Played correctly, a studio could inflict a movie like Gigli on the world and still turn a profit. If box office futures trading happens, being a Hollywood insider would take on a whole new meaning.

Proponents of the concept argue that the plan would simply allow moviemakers to offset their risks. Media Derivatives, Inc., another company that has applied for government approval for a box office futures market, said in a submission to regulators that it wants to enable "risk transfer...from the producers, studios, theaters, and financiers/film funds to a community of speculators willing to assume these risks in return for being paid risk premiums."

Stout says there could be a legitimate case for a futures market limited to players with an economic stake in a movie's success. But Cantor has no plans to restrict trading to those with skin in the game. If it gets the green light from the government, the firm plans to hold "boot camps" across the country to familiarize people with box office futures trading. And it's already recruiting players of its Hollywood Stock Exchange game to set up accounts to "practice" for the rollout of the real market. One New York investment firm, SAGA Capital, has said it will launch a hedge fund focusing on box office futures if Cantor's plan gets the go-ahead.

In other words, Cantor hopes to flood its futures market with plenty of players whose participation would be purely speculative. "In layman's terms, we call that making a bet," Stout says. If that sounds familiar, it should. One of the catalysts for the financial crisis was the spread of risky derivatives like credit default swaps, which allowed investors to bet on whether subprime mortgages would default. Because those investors had no stake in the underlying product—in this case, the original mortgage—they took far greater risks. In that context, Cantor's plan could be "incredibly dangerous," Stout says. "Until we fix this legal problem that you can make purely speculative derivative bets, we have to worry that any newly created form of derivative can add risk to the system."

The Commodity Futures Trading Commission (CFTC) is responsible for approving Cantor's proposal, but refused to comment on the application. A Cantor spokeswoman refused to discuss the firm's plans, saying only that the idea was pending approval. But if the plan succeeds, the amount of money in play could be significant. The movie business brought in around $10.6 billion [6] in domestic box office revenues last year. Because anyone could participate in the Cantor Exchange—not just people who own rights to the box office takings—a futures market could be much bigger.

Tyson Slocum, a futures expert with Public Citizen who advises the CFTC, says Cantor's plan suggests Wall Street hasn't learned its lesson from the crash. Investment firms shoudn't be able to launch new "casinos," he says. The movie business is already an industry based on smoke and mirrors. If Cantor has its way, the fortunes of other financial players could be tied to

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Hollywood's whims. And there's no guarantee of a happy ending.
http://online.wsj.com/article/SB10001424052702303338304575156002283394276.html
Movie Trade Group Objects to Futures Exchange
By NAT WORDEN
MARCH 31, 2010, 2:24 P.M. ET
Major Hollywood studios have sent a message to Wall Street: Greed is not good.
The Motion Picture Association of America has raised objection to two proposals from companies that want to launch financial exchanges allowing investors to speculate on the box-office prospects of Hollywood films by buying and selling futures contracts.
The group's strongly worded opposition led a federal regulatory body, the Commodity Futures Trading Commission, to delay an approval process for one of the exchanges last week. With a decision now expected as soon as Friday, both proposals could be in jeopardy as regulators discern what derivatives trading on films could mean for the entertainment industry.
"Anyone who has followed the meltdown of the financial markets, and the pain this caused people throughout America, knows how important it is to ensure that the establishment of new financial marketplaces does not open the door to rampant speculation and financial irresponsibility," said Greg Frazier, executive vice president of the MPAA in a statement.
Mr. Frazier added that "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."
Trend Exchange, a division of Veriana Networks, a closely held media and technology company based in Scottsdale, Ariz., still expects to receive regulatory approval for a film futures exchange serving institutional clients this Friday and begin trading later this year. The firm believes it could ultimately facilitate futures trading on TV shows, music and other facets of the entertainment industry.
"We respect the MPAA and accept that they have valid concerns, but we believe we have addressed their concerns in our public filings with the CFTC," Trend Exchange Chief Executive Robert Swagger said.
Meanwhile, the Wall Street firm Cantor Fitzgerald plans to begin film futures trading on its Cantor Exchange in late April. If approved, retail investors will be able to open an account on the exchange and begin trading after a three- to five-day background check.
The Cantor Exchange would use a similar format to HSX.com, Cantor's online game site, where players use simulated money to buy and sell shares of actors, directors, coming films, and film-related options.
Proponents of the exchanges say people who finance filmmaking could use these markets to hedge their risks on specific films or a slate of films they are investing in, and thereby have more flexibility to finance filmmaking.
Richard Jaycobs, president of Cantor Exchange, said he was "disappointed" by the MPAA's comments and that the exchange will be a fully transparent and tightly regulated operation.

He also said other market participants, like movie theater owners, film financiers and smaller studios, have privately expressed enthusiasm for the venture.
"There are people who buy Nike stock because they like Nike sneakers, and there are people who buy Disney stock because they like going to Disney World," Mr. Jaycobs said. "There will be people who want to trade futures on our exchange because they like or dislike a movie, but it strikes me as wrong to call those people gamblers."
Both firms, which plan to generate revenue from their exchanges by charging commissions on trading activity, say their products will bring transparency and financial flexibility to an industry that is in need of both. They compare the ventures to oil and commodities futures exchanges, which allow producers to transfer risks to a broader marketplace.
"It gives a lot of power to the folks who want to make films and allows them to find a receptive audience among investors who want to finance those films," Mr. Jaycobs said.
Michael Greenberger, a professor at the University of Maryland School of Law who was the director of the division of trading and markets for the CFTC from 1997 to 1999, said both ventures are simply an attempt to use commodities laws as a way to circumvent state gambling laws.
"These exchanges are designed to simply put money in people's pockets who are running the casino," Mr. **Greenberger** said. "These markets will be run merely as speculative ventures that will only hurt the underlying industry, which doesn't even want it. So little of this money will find it's way into production, that it's not worth it."

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http://www.csmonitor.com/USA/2010/0329/Trading-movie-futures-like-pork-bellies-MPAA-fights-the-idea
By Gloria Goodale, Staff writer, Daniel B. Wood, Staff writer March 29, 2010 at 8:26 pm EDT
Los Angeles — Two firms want to turn America's growing obsession with how much money movies make into a full-blown futures exchange through which investors can peculate on Hollywood profits and losses, much as traditional commodities markets offer wagers on the future prices of pork bellies and orange juice. The two exchanges – one from New York, another based in Chicago – hope to gain approval and open for investors in April. But they have run into a ferocious hailstorm of protest, some from the very folks the financial firms say they hope to benefit, first and foremost – the six major movie studios.
"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," says Greg Frazier, executive vice president of the Motion Picture Association of America (MPAA), in an e-mail. The trade group has requested a period of public discussion before any such exchanges gain final approval from the Commodity Futures Trading Commission (CFTC). Such an airing of industry concerns is a minimum provision in today's troubled financial times, says Mr. Frazier, who adds, "Anyone

who has followed the meltdown of the financial markets, and the pain this caused people throughout America, knows how important it is to ensure that the establishment of new financial marketplaces does not open the door to rampant speculation and financial irresponsibility."

Speculation isn't inherently bad

While the industry registers its protests, media and financial observers suggest that the issue is more complicated. "The MPAA's concerns are a bit overblown – these claims against 'evil' speculators [are] age-old and ring a bit hollow because [they] ignore potentially very useful price signals," says Michael S. Pagano, professor of finance at the Villanova University School of Business in Pennsylvania. "Speculators are not, by definition, bad for society," he says. "In fact, they can be quite good by providing liquidity and price signals that would not exist if these players were not present in the market."

Will it be just another form of gambling?

But box-office analyst Paul Dergarabedian, who aggregates the studio numbers for Hollywood.com, says he is torn over the proposed exchanges. "The box-office chart is already a commoditization of movies," he says, adding that the uproar is just one more chapter in the tension between art and commerce that has dogged Hollywood since its founding.

However, one long-time observer minces no words in his condemnation of the proposals: "This is gambling pure and simple," says **Douglas Gomery**, retired professor of the economics of cinema at the University of Maryland, in an e-mail. "Hollywood specialists have never figured out how to hedge these bets other than to know that 1 in 10 will make a great deal of profit. FYI, three-fourths of critics predicted "Avatar" would be a failure."

Even if the exchanges clear legal hurdles and concerns about insider trading after public hearings are held, their very existence could create a public relations nightmare for the movies. "[The exchanges] are the coming together of art and commerce in yet another extension of that age-old debate," says Mr. Degarabedian. "It might give the movies a black eye if people have lost their shirt, because it might turn them off to movies."

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http://knowledge.wharton.upenn.edu/article.cfm?articleid=2477

Betting on Future Movie Receipts: Beware the Hollywood Lemons

Published : April 28, 2010 in Knowledge@Wharton

In another of his personal finance columns, Wharton professor of insurance and risk management ***Kent Smetters*** *looks at the pros and cons of investing in a new futures exchange -- approved last week by the U.S. Commodity Futures Trading Commission and sponsored by Cantor Fitzgerald investment bank -- that will match buyers and sellers of future movie receipts.*

The movie industry fared well during the current recession, generating record receipts of more than $10 billion in 2009. In fact, demand for movies typically increases during economic downturns even while the demand for most other goods and services falls.

For investors, movies represent a potentially attractive investment. The correlation between annual box office receipts and the Standard & Poor 500 Index is slightly negative, meaning that film investments can still do well while the rest of your portfolio suffers. Moreover, a good blockbuster like Avatar might also produce revenues that are multiples of its costs. There are not many available asset classes that exhibit these sorts of tradeoffs.

So, wouldn't it be great if you could invest in a new film that you thought could be a real blockbuster?

Now maybe you can. On April 20, the U.S. Commodity Futures Trading Commission (CFTC) approved a new movies futures exchange that will match buyers and sellers of future movie receipts. The Exchange is sponsored by Cantor Fitzgerald, a New York City-based investment bank that became a household name several years ago when two-thirds of its employees were killed in the terrorist attacks of September 11, 2001. It has since rebounded with considerable success, in part due to differentiation through financial innovations like this one. Subject to final approval in June, the new Cantor Exchange will allow an investor to invest in his or her favorite movie by purchasing a share of its future revenue stream.

But not so fast. Hollywood studios are up in arms about Cantor Exchange's approval (as well a similar exchange by an Indiana-based startup Media Derivatives). The Cantor Exchange is opposed by the Motion Picture Association of America (MPAA) and the Directors Guild of America. The major studios claim that the Cantor Exchange will lead to speculative bets, insider trading, and false rumors. A rogue employee might even bet against a film's success and use his or her position to ensure its demise. Of course, such an act would be illegal, and similar concerns arise with other companies where it is possible to short the company's stock. The difference here is that an employee might have more substantial control over the success of a single movie relative to the share price of a larger firm.

Last week, Blanche Lincoln, democratic senator from Arkansas and chairman of the Senate Agriculture Committee that oversees the CFTC, agreed with the studios and placed a ban on the Exchange in the most recent version of the financial reform bill that passed her Committee. Maybe coincidentally, Lincoln is the younger sister of Hollywood director Mary Lambert who directed Stephen King's Pet Sematary and other films. The House of Representatives held hearings on April 22, 2010, where Cantor president Richard Jaycobs testified, as did MPAA president Robert Pisano.

Are the studios just looking to protect their own market power when it comes to movie financing? Are investors being cheated out of a decent way to diversify their portfolios? Probably not. In fact, regardless of the true motivations of the studios' resistance, the Exchange itself presents a valuable warning and general lesson for investors: Taking bets on the performance of individual contracts -- in this case, specific movies -- is often subject to the curse of "adverse selection" where only the bad quality product is actually offered for sale. Nobel laureate George Akerlof refers to bazaars likes these as "markets for lemons."

Pork Bellies, Corn and Lemons

The problem is not with futures exchanges themselves. In fact, futures exchanges are a good way for counterparties to hedge their risks. For example, farmer Joe plants his wheat crops long before the price of wheat is determined at harvest time. He is worried that the price of wheat will fall during the time in between. A producer of breakfast cereals, though, is afraid of just the opposite: Prices might increase, reducing the sales of brands which breakfast cereal producers have invested heavily in. So, there are mutual gains from trade if the two parties agree to a future sale price at delivery that is close to the price today. Both parties hedge against the price moving in the direction that is harmful to their own interests.

Trillions of dollars are traded each year in contracts like these for all sorts of commodities, including pork bellies, corn, oil and exchange rates on currency. In theory, a movie exchange should allow a studio to also diversify its future risk by effectively selling some of its unpredictable future cash flow for guaranteed money today. In a break with most other studio executives, Lionsgate's vice-chairman Michael Burns wrote to Congress that such contracts "would substantially widen the number and breadth of financing sources available to the motion picture industry by lowering the risk inherent in such financing." Outside investors might like the opportunity to bear this risk because it gives them a potentially profitable investment while allowing them to further diversify their portfolio with a unique opportunity.

But a movie exchange fails to appreciate the economics behind a market for lemons. Whenever the product being offered for sale varies in quality -- and the sellers have more information about its true value than buyers -- the low quality variation is what tends to get sold. In other words, the Cantor Exchange could end up only selling movies that studios know are real lemons based on their internal market testing.

The reason why traditional commodities exchanges, like wheat or currency, work so well is that buyers and sellers have fairly equal information about the underlying risks. Moreover, the goods being traded are somewhat standardized, so that sellers can't pick off only the low quality product to sell. In fact, marketers commonly refer to the "commoditization" of a product to suggest that it has very little quality differentiation.

But movies are not commodities. Indeed, studios have considerable private information about the quality of a movie before it is released. According to movie industry expert Tamara Rothenberg, that's the reason why "film studios often embargo reviews for bad movies until after release or offer no pre-release screenings." Wharton marketing professors Jehoshua Eliashberg and John Zhang have even developed their own sophisticated models that would help movie studios predict sales prior to release based on their internal testing. Armed with this information, studios with lemons would be incentivized to issue sell orders on the Cantor Exchange.

The nature of the flow of information is what ultimately dooms a movie exchange. The first piece of objective market-based information only becomes available once the movie is released. But by that point, it's too late for a futures exchange to add much value since most of the uncertainty has already been resolved. Indeed, movies often sink or swim based on word of mouth and online reviews during the first weekend; in addition, first-week box office sales are highly predictive of future sales. According to Wharton marketing professor **Eric Bradlow**, "there is a lot of recent research on the ability of user-generated content to predict movie box office performance." Twitter chats during the first weekend, he adds, appear to be more predictive than the Hollywood Stock Exchange, a fantasy movie trading game, also owned by Cantor.

Instead, the new Cantor Exchange will likely encourage studios to simply "pump and dump" their lemons. Wharton's **Justin Wolfers**, professor of business and public policy and an expert on prediction markets, is another skeptic of the Cantor Exchange. "Most major studios are well diversified. They make dozens of movies. The studios can also diversify and spread risk in other ways, by taking on more partners or restructuring the contracts with their stars." Indeed, private equity funds already provide capital directly to studios. They attempt to reduce the lemon problem by offering to fund a large slate of movies (pdf) rather than allowing a studio to simply pick the movies to be financed.

The market for lemons raises serious issues of transparency and is one reason why mortgage-backed securities like Collateralized Debt Obligations failed so miserably, leading to a collapse of the larger financial system in 2008. CDOs can vary substantially in the quality of the mortgages they hold. The seller -- in this case, the bank that originated the loan -- has more information about the quality of CDOs than many buyers. Not surprisingly, ample evidence exists that the mortgages that were resold to outside investors in the form of CDOs were more likely to fail (pdf) than mortgages that the originating banks simply kept on their own books.

Going to the Dogs -- But suppose that you want to invest in movies while avoiding lemons. It's actually pretty hard as an individual investor. You cannot directly invest in any of the major "Big Six" studios. Each one is owned by a larger parent company. For example, Universal Studios is owned by General Electric but its impact on GE's return on equity is very small. DreamWorks, the studio behind the Shrek franchise, is an exception since it offers a more direct investment in its movies, but its price has already doubled during the past year. So unless you have access to a related private equity fund, there is only limited opportunity to directly invest in movies.

The Cantor Exchange, therefore, is appealing in that it tries to "democratize" movie investments. But, as **Wolfers** puts it, "investors have got to be worried that studios would only want to short their dogs." Indeed, movie financing is probably best left to the pros.

The general lesson is that, as an individual investor, you should be suspicious of investing in any individual contract where the seller has a lot more information than you. Instead, simply make sure that your portfolio includes some recession-proof stocks. Companies like Wal-Mart, McDonalds, Hasbro, Yum! Brands, and Procter and Gamble often see higher (or still fairly robust) revenues during recessions. But don't overdo it: These revenue streams might also fall as the economy rebounds.

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http://www2.macleans.ca/2010/04/08/a-futures-market-for-film-buffs/
Macleans--printed on May 10, 2010
Canada's only national weekly current affairs magazine.
A futures market for film buffs
Apr 8, 2010 by Tom Henheffer
Movies are about to join the likes of corn and crude oil with their own futures market. Cantor Futures Exchange, a subsidiary of brokerage firm Cantor Fitzgerald, is planning to launch a new online market next month where investors will be able to buy futures contracts on box-office revenues, allowing film buffs and Hollywood studios alike to place bets on how much cash movies will earn.
"There are a lot of people that have opinions on what films will make," says Richard Jaycobs, president of Cantor Fitzgerald. "We've got to bring all the constituents in the marketplace together." The contracts trade at $1 for every $1 million a movie is expected to gross in its first month, so for every million a film takes in over projections, investors can gain another dollar on their investment. It seems simple, but box-office predictions are notoriously inaccurate, which leaves a lot of potential to both make and lose cash. "There's no question. It's risky," says Jaycobs.
Anyone can buy the contracts, but the market is primarily meant to serve as an insurance policy for studios that want to hedge their investments. They can sell shares of their movies to speculators, spreading the possible risks. But the trade has at least one big drawback. "This is the type of product someone could cheat with," says University of Toronto management professor **Eric Kizner** [sic]. He says it will be difficult to prevent studios from over- or under-inflating projected box office numbers. Changes in advertising or a leak of bad news from on set, he says, could alter expectations, increasing possible profits for insiders. The Motion Picture Association of America has also spoken against the new market, saying it's little more than "unbridled gambling."
Still, both Jaycobs and **Kizner** [sic] feel box-office futures have potential. "It's kind of sexy to show up at a cocktail party and talk about your shares in Avatar," says Kizner.

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http://www.canadianbusiness.com/markets/stocks/article.jsp?content=20100426_10009_10009
From Canadian Business magazine, April 26, 2010
Futures markets go Hollywood: With credit in a crunch, futures markets allow film studios to sell themselves short.
By James Cowan
Futures markets traditionally trade in fairly workaday commodities, like corn, cotton and pork bellies. Two new markets, however, intend to offer investors a chance to buy into something with a bit more razzle-dazzle — Hollywood movies. The Cantor Exchange, a subsidiary of New York brokerage Cantor Fitzgerald, offers moviegoers a chance to make money by speculating on

a film's domestic box-office revenue. The Trend Exchange, owned by Veriana, a private technology firm based in Scottsdale, Ariz., intends to offer a similar service exclusively aimed at studios, producers and other film-industry insiders.

Both exchanges still need final regulatory approval, but Cantor's offering is modelled on the Hollywood Stock Exchange, a popular website purchased by the company in 2001. Not unlike fantasy baseball league for movie fans, the site lets aspiring moguls buy into upcoming releases using valueless "Hollywood Dollars." Cantor contracts will trade at $1 for each $1 million that film is projected to make in its first month of release. For example, contracts for A Nightmare on Elm Street, a remake of the 1984 horror film, recently sold for $94 apiece, meaning the market expects the film will earn $94 million in its first four weeks. If the movie makes more than that, investors with Nightmare contracts will make money. If an investor finds the projections overblown, they can sell the flick short and profit when it fails to meet horror fans' expectations. Scheduled for an April 30 release, Nightmare could be among the first films listed on the exchange if Cantor receives final approval on April 24. Other early contenders include The Losers and Iron Man 2.

By allowing studios to take out contracts against their own films, movie futures offer a way to mitigate the risks of budget overruns and bad reviews just as traditional futures markets allowed farmers to hedge against drought and locusts. Contracts on the Trend Exchange will likely be priced from $100,000 — enough money to hedge against the costs of a multimillion-dollar film. "The slight wrinkle comes with the nature of the good," says Russ Andersson, director of risk management and analytics with Veriana. "A movie is not storable, it's not transferable and it has some very strange supply-and-demand dynamics. It takes a lot of time and money to create a movie, and the success of that movie is pretty much going to be determined within 72 hours on opening weekend."

Trading strategies would also be more complex for movie futures than corn or cotton, says **S. Abraham Ravid**, a finance professor at Rutgers University and a visiting professor at the University of Chicago. "Futures are generally in standardized commodities," he says. "Films are anything but."

Film futures might facilitate a much-needed injection of cash into the industry, according to Alex Costakis, the managing director of the Hollywood Stock Exchange. "With the financial crisis, there's been a pullback in a lot of the credit that was available in the marketplace, and not as many films in production," he says. "So the industry is looking at this as a new vehicle for possibly hedging costs and risks."

But while the industry may be intrigued, it is also skeptical. The Motion Pictures Association of America, an industry lobby group, sent a letter to the Commodity Futures Trading Commission, complaining "the reputation and integrity of our industry could be tarnished" by allowing "the economic equivalent of legalized gambling on movie receipts.

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http://news-releases.uiowa.edu/2010/april/041210IEM-boxoffice.html
University of Iowa News Release, April 12, 2010

IEM offers lessons in box office prediction markets

A division of the bond trading firm Cantor Fitzgerald is hoping to open its new box office prediction market this month, but the coordinator of the Iowa Electronic Market's movie prediction market thinks traders will have their work cut out for them making money.

"Forecasting movies is a very difficult problem," said **Tom Gruca**, a professor of marketing in the Tippie College of Business who studies the use of prediction markets as a forecast tool. "There's an enormous amount of data out there for traders to aggregate, but how do you put it all together? Nobody's learned yet how to distill all that information into a consistently accurate forecast."

Cantor needs only one final green light from the Commodities Futures Trading Commission to move forward with its prediction market, although opposition from the film industry has currently delayed the project. Once approved, traders on the market will be able to buy and sell contracts based on the box office gross of a movie's first four weeks.

The IEM, operated by the University of Iowa's Tippie College of Business, has been operating a similar real-money box office market since 1995. The market operates primarily as a classroom market for one of Gruca's fall semester graduate level marketing courses, so traders are made up mostly of students and other academic traders interested in learning about prediction markets. Traders buy and sell real money contracts based on their prediction of the opening four-week box office of a film Gruca selects.

The first market opened in 1995, shortly before the opening of another box office futures market, the Hollywood Stock Exchange, a for-fun only market that's also operated by Cantor Fitzgerald.

Since then, **Gruca** said the two markets have shown how difficult it is to accurately forecast box office returns. The IEM's average percentage error is 38 percent, while the Hollywood Box Office predictions for the same movies miss by an average of 31 percent. Compare this to the IEM's presidential vote share market, which has an average error of about 1.8 percent, and the difficulty of forecasting movie box office results is clear.

Like all IEM markets, traders on the movie market are limited to an investment of $500. Cantor's market will have no limit, but **Gruca** said the track records of the IEM and Hollywood Stock Exchange suggest that cash doesn't make much difference in a movie market's predictive ability.

"The real money IEM markets do not improve on the forecasts from the Hollywood Stock Exchange, so financial incentives don't play a big role in obtaining more accurate predictions," **Gruca** said. "Neither of the movie markets does as good a job forecasting as the political prediction markets."

Gruca wrote about the challenges of a box office prediction market in his paper, "Incentive and Accuracy Issues in Movie Prediction Markets," published in 2008 in the Journal of Prediction Markets. The article was co-authored by Joyce Berg, professor of accounting in the Tippie College of Business, and Michael Cipriano, assistant professor of accounting at the College of Charleston in Charleston, SC.