

CLIENT ADVISORY

CFTC Considers Regulation of Prediction Markets

In a concept release issued on May 1, 2008, the Commodity Futures Trading Commission (CFTC) announced that it is reviewing whether and how it should exercise regulatory authority over Prediction Markets (also known as Event Markets or Information Markets).¹ Operators of, and participants in, these innovative and increasingly high-profile markets should not only be aware of the CFTC's interest, but may also wish to take this opportunity to consider how regulation of any type might impact their activities. The CFTC's deadline for comments is July 7, 2008.

PREDICTION MARKETS

Followers of this year's elections have probably heard of the Iowa Electronic Markets (IEM), a facility operated by the University of Iowa Business School. The IEM is an electronic market where anyone may buy or sell futures contracts, with real cash payments, on the outcome of elections. Thus, a trader on the IEM may "go long" a futures contract on Candidate A, with the expectation that if Candidate A wins their election, the trader will receive a cash payout. With multiple parties trading, all of whom have a financial incentive to do research and place intelligent bets, prices of contracts on the IEM are thought to provide an accurate predictor of elections.

Ordinarily, under the Commodity Exchange Act (CEA), futures contracts are subject to regulation by the CFTC. However, as an experimental, not-for-profit market, run by a university for academic purposes, the IEM received two "no-action" letters from the CFTC in the early 1990s. In those letters, without opining on whether trading on the IEM would be subject to CFTC jurisdiction, the CFTC stated that it would not bring an enforcement action against the IEM for operating the markets. Since that time, the IEM has expanded its listings to include futures contracts on such matters as the box-office performance of a movie and even contracts where payouts are determined by the stock price of a publicly-traded corporation (although this market is open only to those affiliated with academia).

Other prediction markets have also appeared, permitting trading on a wide array of events, ranging from the likelihood of a recession, to the outcomes of sporting events, to celebrity marriages. The instruments that these markets trade are called "event contracts" or similar terms.

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This summary is intended to be a general summary of the law and does not constitute legal advice. You should consult with competent counsel to determine applicable legal requirements in a specific fact situation.

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¹ *Concept Release on the Appropriate Regulatory Treatment of Event Contracts*, 73 FR 25669 (May 7, 2008).

THE CFTC'S CONCEPT RELEASE

When a federal agency is considering whether to issue new regulations, its first step is often (as the CFTC has done here) to issue a concept release in which it announces that it is contemplating new rules, and asks any parties interested for information about how a particular industry operates, whether regulation is necessary, and if so, what would be the most appropriate form of regulation. From the information gathered, the agency then decides whether and how to adopt new rules. There is no particular time frame for action.

In this concept release, the CFTC has asked commenters to address a broad range of questions. For instance, the CFTC has inquired whether its jurisdiction should hinge on whether an instrument is used for purposes of hedging and price discovery, or whether certain types of event contracts, such as those based on violent events, should be forbidden. In a brief summary of the agency's concerns, however, the release states that the CFTC wishes to determine

- whether and why event contracts might be subject to the CEA,
- how (assuming that event contracts are subject to CFTC jurisdiction) such jurisdiction should be exercised, or whether event contracts should be excepted from CFTC regulation in some way, shape or form, and
- how the CFTC should address the potential application or pre-emption of state gaming laws with respect to these instruments.²

IMPLICATIONS OF THE CONCEPT RELEASE

Trading in futures contracts is subject to the exclusive jurisdiction of the CFTC. If the CFTC concludes that trading in a given event contract is subject to its authority, a wide array of rules and regulations would suddenly apply to any market that sponsors such a contract, or similar contracts. For example, CFTC rules that currently apply to traditional futures markets include rules that require such markets to register and submit to regulatory inspections, to oversee

members and traders, and to create and maintain records and order audit trails. Although the CFTC has not indicated whether it would do so, it is possible that the CFTC might impose similar obligations on sponsors of prediction markets.

A contract that is not a future, on the other hand, although not subject to CFTC jurisdiction, might be subject to a wide range of other regulatory requirements. For instance, a contract that could be deemed a gaming instrument might be subject to state gambling laws, or federal restrictions on internet gambling. Furthermore, as illustrated by a recent Investor Alert from the Financial Industry Regulatory Authority, other types of instruments, such as "event linked securities" or "catastrophe bonds" (which allow investors to speculate on the likelihood of events such as natural disasters), may take the form of securities subject to federal and state securities laws.

In stating that it is prepared to examine whether certain forms of trading are subject to the CEA, the CFTC is also signaling that it may be willing to declare that other forms of trading are not. Such a declaration might be interpreted by some as leaving the door open to other forms of regulation, such as through the application of state or federal gambling laws. In this light, interested market participants are encouraged to provide their insights to the CFTC, and squarely address whether there are any reasons that prediction markets should be regulated. Commenters may wish to describe the economic nature and purposes of various event contracts, both in general and in particular cases. Commenters should also address how regulation might affect the ability of such markets to generate accurate estimations as to the likelihood of future events.

As a further point for thought, the CFTC's concept release represents not only an opportunity for market participants to provide insight to a potential regulator, but an occasion, during a time of growth in the field, to examine their programs and consider what laws and regulations might apply to their operations. To this end, market participants should anticipate

² 73 FR at 25670.

the concerns that a regulator or consumer protection advocate might have with respect to their activities. For instance, market sponsors may wish to assess the form and content of their communications with the public in order to identify any content that could be deemed inaccurate or misleading. Operators of prediction markets may also wish to review the security of their systems, and reflect on whether personnel that operate their systems should be permitted to trade in their marketplaces. They may also wish to examine whether their systems could be used to effect money laundering, and take steps to prevent it.

The CFTC concept release can be [read in its entirety](#) and can also be found on the CFTC website (www.cftc.gov). Any questions about the CFTC's concept release, including questions related to providing comments, may be addressed to

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