

May 9, 2008

Event Contract Markets

CFTC Issues Concept Release Seeking Comment on the Appropriate Regulatory Treatment of Event Contracts

SUMMARY

On May 1, 2008, the Commodity Futures Trading Commission (“CFTC”) issued a concept release soliciting comment on the appropriate regulatory treatment of financial agreements commonly referred to as event contracts (“Release”). Release 5493-08. The Release was published in the Federal Register on May 7, 2008, 73 Fed. Reg. 25669, and public comments must be received by July 7, 2008. In the Release, the CFTC is seeking public comment as part of a comprehensive review of the appropriate regulatory treatment of event contracts under the Commodity Exchange Act (“CEA” or “Act”).

The Release lays out three broad issues identified by the CFTC in connection with event contracts: (1) whether event contracts fall within the CFTC’s jurisdiction, (2) whether any exemptions or exclusions from the CEA should be applicable to event contracts, and (3) how the CFTC should address the potential gaming aspects of event contracts and the potential preemption of state gambling laws by the CEA. In framing these issues, the Release first summarizes the CFTC’s experience with event contracts. Second, the Release defines event contracts and divides them into three categories: (1) contracts based on narrow commercial measures and events, (2) contracts based on environmental measures and events, and (3) contracts based on general measures and events.¹ The Release goes on to set forth the statutory basis for CFTC jurisdiction over commodity futures and options and to analyze how these bases might apply to event contracts. Finally, the Release raises a series of specific questions on which the CFTC seeks comment.

BACKGROUND

CFTC Jurisdiction

With few exceptions, the CEA grants the CFTC exclusive jurisdiction over commodity futures and commodity options, including certain over-the-counter instruments. Significantly, this exclusive grant of jurisdiction preempts the application of certain state laws, including state gaming laws, to commodity futures and options subject to CFTC jurisdiction, and to transactions excluded or exempt from the CEA. Under the CFTC's analysis, binary event contracts, in which the parties agree to pay out based on the occurrence or non-occurrence of a particular event, closely resemble commodity option contracts, and thus may be subject to CFTC jurisdiction. One example of a binary event contract is a contract based on the outcome of the presidential election. The CFTC also notes that those event contracts that create ongoing obligations that are linked to moving measures or levels, such as the share of votes a candidate receives, are comparable to futures contracts that may fall within CFTC jurisdiction.

The CFTC has jurisdiction over a futures or option contract only if the underlying interest constitutes a "commodity" within the meaning of the CEA. An underlying interest may be classified as a commodity under Section 1a(4) of the CEA if it is within an enumerated list of goods specified in the Act or is encompassed within a catch-all that includes those articles, goods, services, rights or interests "in which contracts for future delivery are presently or in the future dealt in." However, Section 1a(13) of the Act excludes certain underlying interests from the statutory definition of commodity, including (1) any economic or commercial index that is based on prices, rates, values or levels not within the control of any party to the contract and (2) any occurrence or contingency associated with a financial or economic consequence that is not within the control of the parties to the relevant transaction.

If the measures or events underlying event contracts are within the definition of a commodity, then futures or options on such underlyers could be listed for trading on regulated futures exchanges. Moreover, pursuant to the amendments to the CEA enacted under the Commodity Futures Modernization Act of 2000 ("CFMA"), transactions in "excluded commodities," as defined in Section 1a(13), are not subject to any provisions of the Act, provided that they are entered into between "eligible contract participants," as defined under the CEA, and certain other requirements are satisfied.² Accordingly, if the measures or events underlying event contracts are within the definition of "excluded commodities," transactions involving such measures and events entered into between eligible contract participants may be excluded from the CEA. As noted, both exchange-traded futures and options and excluded over-the-counter transactions are eligible for the preemption of state gambling laws.

Development of Event Contracts

The CFTC has encountered a variety of types of event contracts markets over the last few years. One of the better known of these markets is the Iowa Electronic Markets ("IEM"). The IEM is operated by the University of Iowa and is an electronic trading system that allows traders to enter into contracts, the pay-

outs for which are dependent on the outcome of political contests—most notably the U.S. presidential elections. The CFTC allows the IEM to trade such contracts in part pursuant to a no-action letter issued by the CFTC in 1993. That letter also lays out several limitations, such as number of traders and value of contracts, that are intended to limit the IEM to its stated academic purposes. While the CFTC describes the predictive and information aggregation functions of the IEM favorably in the Release, the Release cites other recent event contracts markets with skepticism, e.g., markets based on the length of celebrity marriages and the duration of wars. It was in response to these developments, as well as increased requests for guidance on the propriety of trading certain event contracts, that the CFTC issued the Release seeking comment.

CFTC ANALYSIS AND SPECIFIC QUESTIONS

Types of Event Contracts

In the Release, the CFTC divides event contracts into three separate categories: (1) contracts based on narrow commercial measures and events, (2) contracts based on environmental measures and events, and (3) contracts based on general measures and events. Narrow commercial measures are those that quantify the rate, value or measure of a particular commercial activity, e.g., the earnings of a particular corporation. Narrow commercial events are those occurrences that, while not truly economic in nature, may have particularized commercial effects, such as a change in corporate officers or an acquisition. The Release describes environmental measures as those that attempt to quantify weather phenomena, such as temperature change or annual rainfall. Environmental event contracts are those based on the occurrence or non-occurrence of meteorological events, such as hurricanes or tornadoes in a specific region. General events are those events that that “do not reflect the occurrence of any commercial or environmental event,” e.g., passage of certain legislation or the decision of two celebrities to marry. Likewise, general measures are those that do not quantify the rate, value or level of any commercial or environmental activity—for instance, the number of hours Americans sleep on average each night or the vote-share of a political candidate. The CFTC describes those event contracts that lack a clear commercial purpose as primarily serving "information aggregation" purposes; i.e., providing information as to market or public sentiment on the issues presented by the contracts.

Specific Questions

In addition to soliciting general comments, the CFTC seeks comment on a series of specific questions, which are set forth in the Release. Those questions are divided into three categories. The first category of questions addresses the CFTC’s mandate to protect the public interests, including those interests specifically enumerated in the CEA, and requests comment on the most appropriate criteria by which to measure the potential social value and public interest considerations of event contract markets. The second category of questions relates to the CFTC’s jurisdiction, focusing on the categorization of commodity futures and options, the rationale of the CEA for regulation and the potential for event contracts to be employed for gaming or socially harmful purposes, and the appropriate tests to be

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employed in determining the jurisdictional status of event contracts under the Act. The final category of questions relates to issues that may arise in the legal implementation of regulation to event contracts, as well as other practical considerations, including the types of contracts that should be permitted to trade on exchanges and the approach that should be used by the CFTC in considering exemptions or exclusions for off-exchange transactions.

CFTC STATEMENT AND RELEASE

CFTC Statement:

<http://cftc.gov/newsroom/generalpressreleases/2008/pr5493-08.html>

Concept Release:

<http://cftc.gov/stellent/groups/public/@newsroom/documents/file/eventmarkets050108.pdf>

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ENDNOTES

- ¹ The Release describes event contracts as financial arrangements that generally “are neither dependent on, nor do they necessarily relate to, market prices or broad-based measures of economic activity. Rather, event contracts may be based on eventualities and measures as varied as the world’s population in 2050, the results of political elections or the outcome of particular entertainment events.” Release at 1.
- ² The definition of "eligible contract participant" includes, among others, individuals and entities with at least \$10 million in assets.

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