

Event Markets Evolve:

legal certainty needed

BY PAUL ARCHITZEL

The cover story of the January 2004 issue of *Futures Industry* magazine reported on “event markets.” That article introduced to *FI*'s readers the concept of event markets and described how they operate. In addition, it provided a sample list of event markets and compared the activity in such markets in the U.S. and Europe. The article concluded that “[p]art of the reason for the lack of vibrant commercial growth in the U.S. could be regulatory uncertainty.” This article updates the status of event markets since 2004, describes some of the issues creating the regulatory uncertainty that surrounds these markets and suggests a possible way forward toward greater regulatory certainty.

Event markets—otherwise known as prediction markets, decision markets, digital markets or binary markets—share the common trait that the occurrence that is being traded is a discrete outcome—either the event happens or it does not. The instruments traded in the market are a form of derivative, deriving their value from the occurrence or non-occurrence of the reference underlying. The underlying may be a price level for a commodity or financial instrument or may be non-traditional, such as a natural, political, historical or even a sporting event. Event markets have sparked a degree of interest far in excess of their volume due to the sometimes unorthodox nature of the underlying. For example, in some markets, the underlying may be the result of various elections, the popularity of various movies, or even the selection of the Pope.

The concept of event markets is not new. The Iowa Electronic Markets, launched by the University of Iowa Tippie College of Business, is generally recognized as the first such market. The IEM began in 1988 as an experimental market for predicting the outcomes of various elections, beginning with the 1988 U.S. presidential election. In 1992, the CFTC's Division of Trading and Markets issued a letter determining that allowing this market to operate in connection with the then upcoming 1992 presidential election without requiring it to obtain the CFTC's designation as a contract market “would not be contrary to the public interest.” In reaching this conclusion, the letter found persuasive the market operator's lack of compensation and the absence of associated advertising. The letter also made clear that it was not rendering an opinion relating to the potential applicability of state law to the IEM.

By way of illustration, and as explained in greater detail in the 2004 *FI* article, the IEM “winner takes all” form of contract operates as a binary European call option, which pays \$1 to the owner of the option of the primary candidate that is chosen to run in the general election. Owners of options on all other candidates are paid nothing. Market participants can purchase a bundle of options from the market-organizer that they can un-bundle and resell in the market, or they can buy the option of a single candidate that has already been unbundled by another participant. The scope of the 1992 letter was subsequently expanded to include markets forecasting the exchange rate of various currency pairs and other economic data and indicators.

Recent Developments in Event Markets

Since *FI*'s 2004 article, there have been three important regulatory developments with respect to event markets. First, the CFTC designated one such market as a contract market, the same designation that applies to traditional futures exchanges. This was the first time that such a market was brought within the traditional futures regulatory structure.

Secondly, the CFTC's Division of Enforcement has brought an action against an event market for operation of a contract market without being designated as such. Finally, an event market has notified the CFTC that it will operate as an exempt board of trade. These developments have the potential to have a lasting impact on the regulatory landscape.

Designation as a Contract Market

The CFTC on February 18, 2004, designated HedgeStreet as a contract market. The designation of HedgeStreet as a contract market is significant because for the first time the CFTC found that a non-intermediated market in binary options offering small-sized contracts met the designation requirements of the Commodity Exchange Act.

HedgeStreet is an electronic trading platform that lists for trading two types of small-sized contracts that it has termed hedgelets. One type of hedgelet is a binary option. HedgeStreet describes the other type of contract that it offers as a “futures” Hedgelet or a “capped futures contract.” The binary option hedgelet offers a return of \$10 to the in-the-money counterparty, and \$0 to the out-of-the-money counterparty. The futures hedgelet offers a return that varies depending upon the ending price of the underlying relative to the contract's range. Because the

range is bounded by both a cap and a floor, the potential loss can be calculated in advance of entering a position. The maximum payout for a “futures” hedgelet is \$50. Positions must be fully paid; there is no margining system, and the market is not intermediated. The underlying commodities include precious metals, foreign currencies, energy, government employment and inflation statistics, housing prices, and interest rates. The HedgeStreet web site notes that these instruments enable individuals to “hedge against risk in your everyday life,” “speculate on economic outcomes” and “profit from your insights if you are right.”

Although HedgeStreet did not file any specific contracts for approval with its application for designation, CFTC staff understood that HedgeStreet intended to list for trading contracts similar to those offered on event markets, but only those having “a legitimate economic purpose and... not contracts based on terrorist activity or gambling activities, such as the outcome of sporting events.”

Order Finding a Violation

Equally significant as its designation of HedgeStreet as a contract market, the CFTC on September 29, accepted an offer by Trade Exchange Network to settle charges that TEN operated a market that offered options contracts to U.S. residents in violation of CFTC rules. TEN is a private, limited liability company based in Dublin, Ireland. It operates an electronic trading platform through a number of web sites, including www.Tradesports.com and www.TradebetX.com. TEN was soliciting U.S. customers through its web sites to enter into (binary) options on energy, foreign currency and scheduled Federal Open Market Committee Rate Announcements. The options traded at values between 0 and 100 with the pay-out determined by whether the strike price was reached.

TEN's offer of settlement requires it to cease and desist from offering options in the U.S. in violation of the CFTC rules and the CEA, to pay a civil money penalty of \$150,000, to inform U.S. residents of the contracts that are unavailable to them, and to ensure that there is not an active online link between its off-shore web sites and that of a U.S.-incorporated entity. This action by the CFTC is significant because it makes clear that it is a violation of CFTC rules to operate a market for the offer or sale of binary European options without being designated, at least with respect to the underlying commodities described in the order. What is less clear, however, is whether that result is true with respect to every type of contract that

could be traded on such a market, including the more exotic markets for political candidates, natural disasters and sporting events.

Registration as Exempt Board of Trade

On November 17, the CFTC acknowledged TEN's notification that TEN intended to operate as an EBOT. Specifically, TEN notified the CFTC that it would operate Intrade Board of Trade as an EBOT. Intrade lists for trading on its platform contracts relating to current events, entertainment, various financial indexes, legal and political events and the weather.

Exempt boards of trade are markets that are largely exempt from regulation by the CFTC. In order to qualify as an EBOT, the market must be limited to participants that are “eligible contract participants,” that is, specified institutional participants or individuals that meet a high net worth requirement. In addition, the commodities that are permitted to underlie contracts listed on an EBOT must have nearly inexhaustible deliverable supplies, be unlikely to be susceptible to the threat of manipulation based upon the size of deliverable supplies and the liquidity of the cash market, or have no underlying cash market. The CFTC in its rules has provided that those commodities that are defined in the CEA as “excluded” commodities and such others as the CFTC determines by rule, regulation or order are eligible to be traded on an EBOT.

EBOTs may not hold themselves out to the public as being regulated by the CFTC and, if found to be a significant source for price discovery must publicly disseminate specified information relating to market volume and prices. The CEA's anti-fraud and anti-manipulation provisions apply to trading on EBOTs.

The notice by Intrade that it intends to operate as an EBOT is another important step in the evolution of event markets. The CFTC's jurisdiction with respect to EBOTs is exclusive. Thus, like fully-regulated contract markets, EBOTs generally are not susceptible to regulation by other Federal agencies. Similarly, EBOTs are not susceptible to regulation by the states, including state anti-gaming statutes or other state gambling regulations.

However, an EBOT is not the only category of exempt market on which binary European options are, or can be, traded. Markets that restrict participants to eligible commercial entities and list contracts only in “exempt” commodities may operate as an exempt commercial market subject to a regulatory framework similar to that which applies to EBOTs.

Moreover, since 2002, Goldman Sachs and ICAP have operated an over-the-counter trading facility that lists contracts in derivatives on various economic indicators. These OTC markets, which limit participants to eligible contract participants, are generally excluded from regulation by the CFTC. These markets do overlap with futures market in certain ways, however. For example, the New York Mercantile Exchange offers clearing arrangements with respect to OTC derivatives on energy inventory statistics and the Chicago Mercantile Exchange offers a trading venue for, and clearing services for OTC digital and plain-vanilla options and forwards on various economic indicators.

Some Regulatory Considerations

The above developments point out four possible outcomes for those wishing to organize and operate event markets. First, the ear-

liest event market, IEM, continues to operate pursuant to CFTC no-action relief. Similar markets that tend to be experimental in nature and are non-profit educational or entertainment enterprises may also be operating in reliance upon the rationale underlying the IEM no-action letter, although at risk for doing so unless they also receive a no-action letter. To date, no market other than IEM has received such a no-action letter. Second, HedgeStreet has chosen to become a fully-regulated designated contract market. However, the relatively high regulatory costs associated with contract market designation may not be compatible with the small-sized contracts generally listed for trading on many event markets. Third, some markets, such as Intrade, have chosen to operate as EBOTs under CFTC jurisdiction but with very little

regulation, or under an exemption or regulatory exclusion that applies to OTC derivatives markets. However, in order to qualify for such an exemption or exclusion, the market is required to limit participants to those meeting specified eligibility requirements and to limit the types of commodities that can be listed for trading. Finally, those that choose “none-of-the-above” face the possibility, illustrated by the TEN settlement, that they may be operating in violation of Commission rules. As the TEN settlement illustrates, event markets that operate in the “none-of-the-above” category do so at their peril, particularly with respect to the commodities described in the TEN settlement (precious metals, energy, FX and Federal Open Market Committee Rate Announcements). But what of markets listing contracts in attendance at movies, or political or legal events or in sporting events? Because choosing “none-of-the-above” may entail significant legal risk, it is crucial that market organizers

are able to understand whether they are covered by CFTC requirements. The answer to that question is not as clear as it could be, and ironically, may raise anew the very issue that bedeviled the futures industry during the early attempts at regulation, namely how to distinguish futures markets from gaming enterprises. For example, as noted above, EBOTs may list contracts in “excluded commodities” or such other commodities as the CFTC specifies by rule, regulation or order. Under the CEA, “excluded commodities” include, among others, any economic index based on prices that are not within the control of any party to the relevant contract and “an occurrence, extent of an occurrence, or contin-

gency that is—1) beyond the control of the parties to the relevant contract; and, 2) associated with a financial, commercial or economic consequence.” A broad interpretation of “excluded commodity” might include betting transactions on sporting and other events. Wagers on sporting events might satisfy the definition because, absent chicanery, the occurrence or contingency is not within the control of the parties to the relevant contract and the outcome may be “associated with an economic consequence,” i.e., a payout to the winner. A narrower interpretation would require the associated financial commercial or economic consequence to be other than a payment to the winning counterparty on the contract itself. However, even under the more restrictive reading, it could be argued that there are general economic consequences that could be associated with the outcome of high-visibility sporting events. These might include increases or decreases in restaurant receipts, subsequent advertising rates in local markets, or sales of particular types of merchandise. A broad reading of “excluded commodity” would therefore make such event-market wagering eligible for listing on an EBOT (albeit only between eligible participants.) Moreover, were such events to be considered to be “commodities,” they might even be offered on designated contract markets without restriction as to market participant. The CFTC has not yet provided guidance, however, as to how it interprets this language.

Public Interest and Economic Purpose

The history of the 1921, 1922, 1936 and 1974 legislation to regulate futures markets is replete with explanations of the hedging utility of futures based on the work of academics such as Holbrook Working, an agricultural economist who advanced the theory of hedging as an arbitrage between spot and futures prices and not merely a transfer of risk to speculators. These explanations were necessary to explain and legitimize futures trading, which too often was linked in popular perception with gambling. This trend was made concrete in the Commodity Futures Trading Act of 1974, which, under Section 5(g) of the Act, included a “public interest” standard for designation of futures contracts. That provision was understood to include “an economic purpose test,” which permitted exchanges to list for trading only contracts that could be used on more than an occasional basis for hedging or price-basing purposes. That provision was removed by Congress as part of its passage of the Commodity Futures Modernization Act of

Event markets are very much like futures in the early days of their regulation—despite a high level of distrust, there is a growing body of economic work that explains the utility that these markets offer. Increasingly, these markets are being recognized as a reliable means of aggregating or centralizing opinion and a more reliable predictor of events than public opinion polling, expert analysis or other methods of forecasting.

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2000, perhaps the ultimate testament to the level of acceptance that the futures industry has achieved over the last 30 years.

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The history of futures market regulation demonstrates that a regulatory scheme can both add legitimacy to a market, as well as help distinguish among various types of economic activity that may be similar in form, but have different purposes and consequences. The requirement that futures contracts be traded only on designated contract markets not only legitimized the futures industry, but distinguished it from the bucket shops that were abusing customers. However, if a new type of market's potential benefit is to be achieved, the applicable rules must be grounded in the economic reality of that market. Accordingly, when the CFTC permitted the reintroduction of exchange-traded options, it appropriately tailored the applicable rules governing their trading. Thus, in addition to providing greater certainty to those organizing event markets, clear rules establishing an appropriate regulatory framework for these markets may very well hasten their acceptance, nurture the benefits that the markets may provide, and help distinguish them from markets that are closer in form and in purpose to mere betting establishments.

A Way Forward

One way that the CFTC could provide greater certainty with respect to event markets is by statutory interpretation. Such a statutory interpretation could establish a bright line demarcating those event markets that could operate only if they become designated contract markets. However, the CFTC may be reluctant to issue a statutory interpretation so long as the markets are rapidly evolving. Moreover, although such an interpretation would add needed clarity, it would do so at the expense of shoe-horning these markets into an ill-fitting regulatory framework.

However, there is another way forward. The CFTC could provide greater certainty to event markets in a manner that would also nurture their unique nature by promulgating a non-exclusive safe-harbor rule under which event markets could operate. The CFTC could promulgate such a rule under its plenary authority to regulate options trading. (Indeed, the TEN settlement was based upon the violation of Part 32 of the CFTC's option rules.) Such a non-exclusive safe-harbor could specify which commodities or events would be included within the safe harbor. This would provide the CFTC with an opportunity to begin to distinguish markets and types of contracts that should be subject to its regulatory remit from those that are not appropriately regulated by the CFTC. It also would enable the CFTC to consider customer and market protection rules tailored to these markets. It would not have any effect on the operation of exempt or excluded OTC markets.

A non-exclusive safe-harbor would not answer every question that has been raised relating to event markets. For example, such a rule would only apply to markets listing option contracts. Moreover, it would not give guidance to market operators who wished to list contracts on commodities or types of events not included within the safe-harbor rule. However, the perfect should not be the enemy of the good. By providing a non-exclusive safe-harbor, the CFTC would enable those markets that wish to be regulated and that meet the requirements that

are specified in such a rule a means of moving forward other than by becoming a fully designated contract market, by finding an exemption or exclusion under which to operate or by operating at their own risk.

Conclusion

Event markets may be at a crossroads in their development. Since *FI* last reported on them in 2004, an event market has become a designated contract market, one has settled an enforcement action and has also notified the CFTC that it would operate as an exempt board of trade. An impressive body of study on these markets now exists that makes the case that these markets may have great social utility. However, other markets which may share the form of the “event” market may not have the same level of social utility, operating mainly as a means of private wagering.

In light of the current state of their development, the CFTC has the ability to profoundly affect the development of these markets. The early history of traditional futures markets shares some common themes with today's event markets; a growing acceptance of the economic utility that they promise along with their popular confusion with less bona fide forms of economic activity. The CFTC has limited resources, but part of its traditional mission has been to foster the benefits engendered by trading on derivatives exchanges by promoting market integrity and customer protection and by safeguarding against systemic risk. In this regard, it is very much in the public interest for the CFTC to provide greater legal certainty with respect to the operation of bona fide event markets. ■

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