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July 7, 2008

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington, D.C. 20581

Re: Concept Release on the Appropriate Regulatory Treatment of Event Contracts, 73 *Fed. Reg.* 25669 (May 7, 2008)

Dear Mr. Stawick:

Crystal World Markets (CWM) welcomes the opportunity to respond to the Commodity Futures Trading Commission's ("Commission") request for comment on the appropriate regulatory treatment of financial agreements offered by markets commonly referred to as event, prediction or information markets. "Concept Release on the Appropriate Regulatory Treatment of Event Contracts," 73 *Fed. Reg.* 25669 (May 7, 2008) ("Concept Release"). The Commission, in its Concept Release, requested comment specifically on the following topics: 1) The public interest in trading such contracts; 2) the Commission's jurisdiction with respect to such contracts; 3) how the Commission would implement its authority over event contracts; and 4) the implications for regulation depending upon the type of market participant.

CWM is a financial services company that is actively involved in bringing the benefits of innovative contracts to market participants. Specifically, CWM is engaged in the research and development of new and innovative derivatives contracts. CWM is currently working with designated contract markets on the design and development of several such innovative contracts. The underlying interests of certain of these contracts are not dependent on market prices or explicit measures of economic or commercial activity. These contracts do, however, track contingencies and risks that have economic consequence for various sectors of business activity.

CWM commends the Commission on its consideration of this important policy issue and is pleased to share its views on the issues raised by the Concept Release.

Importance of innovation

CWM believes that first and foremost, the Commission in framing its consideration of these issues should be guided by the emphasis that Congress has placed on protecting innovation in the regulation of futures markets.

Congress' intent that the regulation of futures markets by the Commission support market innovation is a recurring theme throughout the Commission's history. The Congressional mandate to the Commission to promote innovation was an important factor in the Commission's creation. For example, in 1974, Congress was aware that non-traditional futures contracts, such as possible futures contracts on mortgages and ocean-freight rates, were being developed.[1] Congress did not seek to block the growth of innovative futures trading. Rather it expanded the definition of "commodity" from the enumerated agricultural commodities to "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in," intending that such innovative contracts would come within the regulatory purview of the new Commission.

Congress reaffirmed its support of market innovation in the Futures Trading Practices Act of 1992 (the "1992 Act") by granting the Commission broad authority to exempt any agreement, contract or transaction from any of the provisions of the Commodity Exchange Act, 7 U.S.C. §1 *et seq.* ("Act"). Specifically, the 1992 Act added Section 4(c)(1) to the Act, which provides the Commission with broad exemptive authority, "in order to promote responsible economic or financial innovation and fair competition.[2]

Congress' intent that the regulatory framework bolster market innovation was clearly expressed in the ground-breaking Commodity Futures Modernization Act of 2000 (CFMA). The CFMA fundamentally altered the regulation of futures trading in the U.S. by replacing prescriptive, one-size fits all regulation with tiered, principles-based regulation of markets and clearinghouses. The fundamental building block of the CFMA's architecture is choice—a market is permitted to choose a lower tier of regulation by limiting the nature of the contracts and participants that it admits for trading. Of equal importance is the fact that nothing prohibits a market from opting for a

[1] *See e.g.* H.R. Rep. No. 975, 93rd Cong. 2d Sess. 76 (1974).
[2] Section 4(c)(1) of the Act provides that the Commission may exempt any contract, agreement or transaction from any of the provisions of the Act if the exemption is consistent with the public interest. The Conference Report to the 1992 Act stated that the public interest should include the national public interests of the Act, the prevention of fraud and preserving the financial integrity of the markets, *in addition to promotion of responsible economic or financial innovation* and fair competition. House Conference Report No. 102-978, p.78.

higher regulatory tier than that which would otherwise apply.[3] Since its enactment, the CFMA has become a benchmark for regulatory reform efforts.[4] One of Congress' primary purposes in enacting the CFMA was to "to promote innovation for futures and derivates."[5]

The Commission has heeded the Congressional directives to foster market innovation, paving the way for many market advances. Under the Commission's administration of the Act, financial futures were introduced and exchange-traded options were re-introduced. The introduction of financial futures included the groundbreaking introduction of cash-settled futures contracts. Cash settlement for the first time made possible the trading of futures contracts on intangible "commodities"—that is, contracts that are not capable of being delivered. Included within this category are various formulas or mathematical constructs; these may relate to the price level of various indexes, including equity indexes, or they may be for contracts on an underlying that is not related to price levels or broad measures of commercial activity, such as contracts on weather and climate conditions, crop yields, bankruptcy filings and events such as the possible merger of two companies. Most of these innovations have gained widespread acceptance and are now commonplace tools of the market. It is easy to forget that when introduced, each of these instruments was revolutionary and skeptics often questioned whether the innovative trading instrument was subject to the Act and to the Commission's regulatory jurisdiction. For example, prior to their approval by the Commission, some argued that cash-settled contracts could not possibly fall within the definition of "contracts for future delivery" under the Act.[6] Similar doubts were raised with respect to weather futures, crop yield contracts credit default event futures contracts and others. In each of these instances, the Commission, to its credit, has leaned toward fostering market innovation.

Products Eligible for Trading on Contract Markets

Based upon its past history of fostering innovation in market products, and the intent and structure of the Act as amended by the CFMA, the Commission should affirm a policy of permitting the broadest range of futures and option contracts to be traded on designated contract markets permitted under the Act. In this regard, the Commission in

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[3] *See, "A New Regulatory Framework, Report of the Commodity Futures Trading Commission Staff Task Force,"* (February 2000) ("Staff Report"). The CFMA grew out of the Commission's regulatory reform recommendations. The Staff Report noted on page 3 that, "the task force suggests that the Commission's regulatory framework . . . to the degree possible . . . rely on voluntary submission to Commission oversight." Thus, even if a market limits the contracts traded thereon to contracts in excluded commodities and its participants to eligible contract participants, it would not be prohibited from opting to subject itself to the full panoply of regulation and applying for designation as a contract market.

[4] *See "The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure"* (March 2008) at http://www.treas.gov/press/releases/reports/Blueprint.pdf, pp. 11-12.

[5] Section 2(6) of the Commodity Futres Modernization Act of 2000, Pub. Law No.106-554, 114 Stat. 2763.

[6] *See* Paul M Architzel and John P. Connolly, *"Delivery on Futures Contracts as A Legal Requirement,"* 36 Bus. Law. 935 (1981).

the Concept Release looks to former section 5(g) of the Act for guidance with respect to which contracts may be listed for trading by a contract market. Concept Release at 25672. However, as the Commission notes, this provision was repealed by Congress in 2000. Congress, through its enactment of the CFMA, rejected the prior requirement that a contract market must demonstrate that a proposed futures contract satisfies the economic purpose test that was embedded in the public interest test of former section 5(g). For the Commission to resurrect this requirement would be an unwarranted backwards step and contrary to the intent of Congress. Accordingly, the Commission should look primarily to the Act as amended by the CFMA for guidance with respect to defining the scope of "commodity" within the meaning of the Act.

As the Commission notes, the term "excluded commodity," which was added by the CFMA in 2000, is defined in section 1a(25). "Excluded commodities" are a subset of "commodity" and therefore logically must fall within the meaning of "commodity" under the Act. "Excluded commodities" include "any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract. . .," or "an occurrence, extent of an occurrence, or contingency . . . that is (I) beyond the control of the parties to the relevant contract . . . and (II) associated with a financial, commercial, or economic consequence." Section 1a(13)(iii) and (iv) of the Act.

In formulating the definition of "excluded commodity," Congress steered clear of the language of the economic purpose test of former section 5(g). Congress, at the time it enacted the CFMA,[7] was aware that the economic purpose test was incorporated by the Commission in Guideline No. 1 of the Commission's rules and chose nonetheless to repeal section 5(g) of the Act. Congress at that time chose to use different wording from the old economic purpose test in the definition of "excluded commodity"—an occurrence or contingency "associated with a financial, commercial or economic consequence." The Commission has offered a gloss on this language in the Concept Release, noting that contracts previously listed by exchanges "have[] generally-accepted and predictable financial, commercial or economic consequences." Concept Release at 25671. This formulation, however, grafts additional concepts onto the language of the Act that may raise the bar higher than where Congress placed it.

The Act's language does not require that excluded commodities based on an occurrence or a contingency have a *generally accepted* and *predictable* financial, commercial or economic consequence. The Commission's formulation may lead to imposing a requirement that the designated contract market demonstrate, prior to listing an innovative product, that the proposed new contract already enjoys market acceptance or that it enjoys a stable, 'predictable,' basis relationship with the underlying commodity. It is unlikely that contract markets, when first proposing weather contracts, could have demonstrated that their utility was generally accepted or whether they would exhibit a

[7] Guideline No. 1 has been retained by the Commission as part of its acceptable practices following enactment of the CFMA and is now found as Appendix A to Part 40. The economic purpose test is contained in 17 C.F.R. Part 40, Appendix A, §(a)(4).

predictable basis relationship to the underlying. Both of these issues may not be susceptible to proof prior to a contract's listing for trading. These issues are better left to the market to decide, based upon trading and market experience, as Congress intended through the 2000 amendments to the Act.

Accordingly, the Commission, in any subsequent action that it takes with respect to event contracts, should make clear that a designated contract market may self-certify (or be approved by the Commission to list a contract if it so requests)[8] a futures or option contract on an underlying interest that meets the definition of excluded commodity. As the Commission noted, "excluded" commodities are a subset of "commodity" as defined by the Act, and thus the Commission would be establishing a safe-harbor, rather than delineating its jurisdictional boundaries. This safe-harbor approach also could be extended by the Commission, as appropriate, to additional services, rights or interests that may not satisfy the definition of "excluded commodity," but which are appropriately classified as commodity futures or options. By taking this approach, the Commission would ensure that it does not impede innovation of new products that Congress has defined as being within the scope of the Act, while leaving open the possibility of addressing particular commodities that are not included within the broad safe-harbor, as examples arise.

A safe harbor approach is also useful because it can be used to identify instruments that clearly are outside of the Act's jurisdiction. In this regard, the Commission, in its Concept Release, has raised the issue of how it could distinguish event contracts that are within the Act's broad definition of "commodity" from gaming contracts. Concept Release at 25673. Gaming contracts might be thought of as contracts that are dependent upon the outcome of discrete events that are not associated with a financial, commercial or economic consequence, but rather have utility only for their entertainment value. Thus, a contract that is contingent upon the outcome of a specific sporting event is unlikely to be associated with a financial, commercial or economic consequence and its primary or sole utility to the parties entering into the contract is its entertainment value. The staff, in designating HedgeStreet as a contract market, implicitly adopted this line of reasoning by accepting HedgeStreet's undertaking not to list binary event contracts on the outcome of sporting events. In so doing, staff noted that such contracts lacked a "legitimate economic purpose."[9] The Commission could also find guidance in various Federal statutory definitions of "gaming" or "wagering."[10]

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[8] 17 C.F.R. §40.3 establishes a procedure for the voluntary submission of new products by contract markets for Commission review and approval.

[9] "Designation Memorandum of Hedgestreet, Inc.," from the Division of Market Oversight to the Commodity Futures Trading Commission, dated, February 10, 2004, http://www.cftc.gov/files/opa/press04/opahedgestreetdesignationmemo_web.pdf, footnote 3.

[10] For example, as discussed infra, the Unlawful Internet Gambling Enforcement Act of 2006 includes a definition of wagering or betting. *See also*, footnote 11.

In offering a definition of gaming contracts which are outside of its jurisdiction (and thus may not be listed for trading by a designated contract market), the Commission should take care to distinguish event contracts on the outcomes of discrete sporting events[11] from contracts on an underlying sports-related service, right or interest that is associated with a financial, commercial or economic activity and that is not dependent on the outcome of a specific sporting contest. There are many types of contracts which may be developed that could be associated with the financial, commercial or economic aspects of the business operations of sports enterprises. As any other business, sports businesses generate significant revenue streams from ticket sales, sales of licensed merchandize and other sources. In this regard, various commercial enterprises may have hedgeable risks or require a means to manage or shift risks that relate to the financial, commercial or economic consequences associated with operation of a sports-related business or sports organization. Contracts addressing these business needs would serve *bona fide* business purposes, would fall within the Congressional definition of "excluded commodity," and would even likely meet the former economic purpose test as being able to be used for hedging or price basing purposes on more than an occasional basis. The Commission should take care in any guidance or rules that it proposes to distinguish this type of *bona fide* contract from contracts that might constitute gaming contracts.

Accordingly, CWM believes that the Commission should make clear in any guidance or rules that the Commission proposes that a designated contract market may list for trading any futures or option contract, including binary option contracts, as long as the contract falls within the broad meaning of "commodity" under the Act. This would include any underlying service, right or interest that meets the plain language meaning of the Act's definition of "excluded commodity" and would include, among others, any underlying that is an occurrence beyond the control of the parties to the relevant contract and associated with a financial, commercial or economic consequence, or any index based on rates, values or levels that are not within the control of the parties to the contract. CWM further believes that it is important that the Commission, in distinguishing contracts that fall within the Act from gaming contracts, recognize the distinction between contracts on discrete sports-related events or outcomes which are commonly included in definitions of "gaming" from contracts for services, rights or interests that are associated with the financial, commercial or economic consequences of operating a sports-related business. Such sports-related contracts, which are not dependent upon the discrete outcome of a sporting event or contest, clearly would meet the criteria for regulation under the Act.

With these general comments in mind, CWM is pleased to address the specific questions raised by the Commission. As appropriate, CWM has grouped together various questions for response.

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[11] Sporting contests or events are typically included in definitions of "gambling" or "wager." 18 U.S.C. §1955 and 26 U.S.C.§ 4421 also define "gambling" or "wager."

Public Interest

1. What public interests are served by event contracts that are designed and will principally be traded for information aggregation purposes and not for commercial risk management or pricing purposes?

2. How are these interests consistent with the public interest goals embodied in the Act?

CWM develops contracts that are associated with a financial, commercial or economic consequence to be listed for trading on designated contract markets. The Commission has noted that contracts that "generate trading prices that predictably correlate with market prices or broad-based measures of economic or commercial activity. . . are unambiguously subject to CFTC regulation." Concept Release at 25669 note 2. CWM agrees with the Commission's conclusion, but notes that correlation with "broad-based measures of economic or commercial activity" may be too narrow a formulation for defining those contracts that clearly fall within the scope of the Act. For example, there are many potential examples of contracts that generate trading prices associated with a financial, commercial or economic consequence that may not measure broad sectors of the economy. These contracts nevertheless may fulfill the same functions, but for more discrete economic activities. The public interest served by such contracts is exactly the same as those served by contracts that are broad-based measures of economic activity. They provide a means of risk shifting and, through the discovery of prices traded on the market, information that can be used in the allocation of economic resources.

Contracts that are traded purely for information aggregation purposes, so long as their trading is associated with a financial, commercial or economic consequence, are likely to serve the same public interest as traditional futures contracts, albeit in a less linear fashion. Among the Commission's examples of event contracts is "accomplishment of certain scientific advances." A contract on development of a certain type of long-lasting battery, for example, would be useful for both risk shifting and price discovery purposes. Certainly, those engaged in funding such research might make use of such a contract to transfer some of the risk associated with unforeseen development delays.

Moreover, the trading prices discovered in the market would provide important information to the markets generally, which could be used in efficiently allocating resources. The discovery of market prices in a traditional futures contract can be used in exactly this way—higher prices signaled by futures trading may be used as a signal by economic actors in the allocation of resources. For example, a producer seeing a high futures price for a commodity might decide to increase production in that commodity. Similarly, pricing signals from a contract on the introduction of a new battery might

cause a manufacturer to invest greater resources in research and development, to make the changes necessary to manufacture a new generation of batteries, or to forego new investment in the existing technology.

Such use of prices generated from trading fits within the Section 3 findings that transactions subject to the Act are affected with a national public interest by providing a means of "disseminating pricing information." Note that section 3 distinguishes between "discovering *prices* or disseminating pricing *information*." Thus, section 3 distinguishes between the discovery of prices themselves and making publicly available pricing information. By using different words, it is reasonable to infer that Congress intended to include within this provision different concepts. It is also reasonable to infer that "price basing" is intended to relate directly to the price of the commodity and "disseminating pricing information" is intended to include a broader concept than mere "price basing." In this way, a non-price-related underlying, when traded on a contract market may nevertheless result in the dissemination of pricing information. For example, a crop yield contract may not be usable for discovery of the price of a commodity, but it may provide pricing information that can be used in resource allocation. This is similar to the benefits available from trading in a scientific or other event contract.

3. What calculations, analyses, variables, and factors could be used to objectively determine the social value of information to the general public that may be discovered through trading in event contracts? Should this be a factor in determining whether the Commission plays a role in regulating these markets?

A designated contract market should be able to list any futures or option contract on a commodity with no further calculation or analyses. Congress, in repealing section 5(g) and in removing the requirement that contract market designation be on a contract-by-contract basis, intended that designated contract markets no longer be required to justify that trading in a particular contract meets a specific statutory test (other than meeting the applicable Core Principles of the Act) prior to its self-certification by the contact market. Where a contract on an occurrence is associated with a financial, commercial or economic consequence, the contract would clearly be a commodity and should be able to be listed through exchange self-certification or through voluntary approval with no special demonstration or analyses. There should not be separate tests requiring contracts based on an occurrence to prove the value of the pricing information disseminated by the market. Rather, it can reasonably be inferred that an event contract that is associated with a financial, commercial or economic consequence will also fulfill the public interest goals of the Act with respect to the dissemination of pricing information.

As discussed above, Section 5(g) of the Act, the statutory provision underlying the Commission's previous requirement that a designated contract market demonstrate that a commodity futures or option contract that it proposes to list for trading fulfill a hedging or price basing function on more than an occasional basis, was repealed in 2000.

In repealing this provision, Congress clearly expressed its intent that designated contract markets no longer be required to make a demonstration of the economic utility of each new futures or option contract prior to its listing for trading. Congress replaced that requirement with the condition that a contract market self-certify new futures or option contracts (or request Commission approval of them) prior to listing.[12] Accordingly, if a market has applied to be, and been designated, as a contract market, and complies in all respects with the Act and Commission rules thereunder, the Act permits it to list futures and option contracts on any underlying that is a "commodity" within the meaning of the Act.

It follows that any contract which meets the definition of "excluded commodity" should be eligible for trading on a designated contract market with no special or different procedures. The definition of "excluded commodity" is very broadly crafted, referring to more than indexes and other intangible constructs relating to prices. This is unsurprising in light of the fact that contracts on weather, climatic conditions and crop yields had been previously approved by the Commission or were widely discussed at the time of the 2000 Act. Thus, Congress defined excluded commodities to include an occurrence, extent of an occurrence or contingency.

It further follows that the Commission's analysis should focus on whether an instrument is a contract for future delivery or a commodity option. If the answer is in the affirmative, then the next question is whether the underlying service, right or interest fits within the statutory meaning of "commodity." CWM believes that Congress' intent was to interpret the meaning of "commodity" using a very broad net based on the open-ended language of the term "commodity" as defined in the Act and the very broadly worded definition of "excluded commodity." If the underlying interest is a commodity within the meaning of the Act, absent an exemption, such contracts are required to be traded on a designated contract market, and a designated contract market is free to list them without demonstrations with respect to their economic utility.[13]

Based on the above, the Commission, in its guidance or in proposed rules, should specify by means of a safe harbor the types of underlying services, rights or interests that, in its interpretation of the Act, are not, and can not be, associated with a financial, commercial or economic consequence. Where there is ambiguity with respect to whether an underlying service, right or interest falls within the Commission's safe harbor, the Commission should establish an expedited, fast track procedure for reviewing the contract market's determination, subject to the staff's negative consent.

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[12] The Act retains various Core Principles such as not being readily susceptible to manipulation to which the exchange's self-certification applies.

[13] As the Commission correctly notes, Section 4(c) empowers the Commission to exempt classes of transactions from any of the requirements of the Act without first making a determination that the instrument falls under the Act. This is an alternate response that can appropriately used where the Commission has not found that a particular type of instrument is subject to the Act.

Jurisdictional Determinations

4. What characteristics or traits are common to or should be used to identify event contracts and event markets?

5. How do these characteristics and traits differ from those of commodity futures and options contracts that customarily have been regulated by the Commission? How are they similar?

6. Are there criteria based on the provisions of the Act that could be used to make jurisdictional determinations with respect to event contracts and markets?

7. Given the purposes and history of the Act, would it be appropriate for the Commission to apply a test premised on commercial risk management or pricing functions to demarcate the Commission's jurisdiction over particular contracts? If so, what factors could be used to make such a determination?

8. Given the purposes and history of the Act, would it be appropriate for the Commission to apply any test premised on the economic purpose of certain types of transactions to demarcate the Commission's jurisdiction over particular contracts? If so, what factors could be used to make such a determination?

9. What calculations, analyses, variables and factors would be appropriate in determining whether the impact of an occurrence or contingency will result in a financial, commercial or economic consequence that is identified in Section 1a(13) of the Act?

First it is important to note that the statutory language defining an excluded commodity is "an occurrence . . . or contingency that is *associated* with a financial, commercial or economic consequence." As noted above, the Concept Release does not always use the language of the Act in describing this term. Factors that would be appropriate in determining whether a financial, commercial or economic consequence is associated with the service right or interest underlying a futures or option contract include whether the underlying interest has possible or probable linkages to financial, commercial or economic decisions by a significant number of persons or entities in the economy beyond just those linked directly to the event and whether the relative economic consequence is sustained over a time period not limited to the event itself.

For example, the Concept Release points to contracts on celebrity marriages as a possible type of "event contract." Whether the marriage occurs has a potential economic impact on the couple, such as potential tax and other economic consequences. It also may have a consequence for those businesses that may or may not be service providers to the wedding and associated festivities. However, the event is unlikely to be associated with

an economic consequence for those not directly involved in the underlying event. In contrast, the possible merger of two companies is likely to be linked to generalized economic consequences. These may include consequences for shareholders of the companies (which may be significant in number), for market competitors, for suppliers and customers of the companies, for service providers and for companies that deal with each of the above. Moreover, the economic or commercial effect is not only generalized, it is also capable of being sustained for a period of time beyond the actual event. Whatever the effect of the celebrity marriage, it is likely to be limited in time to the event itself. Thus, as a general basis for distinguishing whether an underlying service, right or interest is associated with a financial, commercial or economic consequence, CWM would consider two factors: 1) The degree to which the related effect is generalized; and 2) the degree to which the effect is sustained beyond the occurrence of the event itself. The greater the foregoing, the more clearly the underlying falls within the statutory definition. The more circumscribed the foregoing, the more attenuated will be the contract's claim that the event is associated with a financial, commercial or economic consequence.

10. What calculations, analyses, variables, and factors would be appropriate in determining whether an economic or commercial index that is based on prices, rates, values, or levels should or should not qualify as an excluded commodity under Section 1a(13) of the Act?

CWM believes that the plain language of section 1a(13) indicates that Congress defined any economic or commercial index based on prices, rates values or levels that are not within the control of any party to the relevant contract, agreement or transaction as an "excluded commodity." By using the words "economic or commercial index" the language would appear to connote that the underlying index have utility beyond the mere entertainment value that might be derived from trading an agreement, contract or transaction on the underlying service, right or interest. Moreover, the definition requires that the index not be within the control of any party to the transaction. This suggests that the index be based on objective criteria and be formulated by a non-trading party. Thus, indexes formulated by an independent entity for economic purposes unrelated to trading in a contract based thereon clearly would fall within the definition.

11. What identifiable factors, statutorily based or otherwise, limit the events and measures that may underlie event contracts when such contracts are treated as Commission-regulated transactions?

12. What objective and readily identifiable factors, statutorily based or otherwise, could be used to distinguish event contracts that could appropriately be traded under Commission oversight from transactions that may be viewed as the functional equivalent of gambling?

Congress has provided definitions both of commodities under the Commission's jurisdiction as well as gaming contracts. These definitions provide a good starting point for delineating the bounds of Commission jurisdiction in this area. The definition of 'excluded commodity,' as the Commission has noted, includes 1) any index based on values or levels that are not within the control of any party the agreement; and 2) an occurrence or contingency that is associated with a financial, commercial or economic consequence. These definitions would apply to many of the examples of 'event" contracts that take the form of futures contracts and of binary options. Clearly, a futures contract that meets the definition of excluded commodity falls within the Commission's jurisdiction and should be permitted to trade on a designated contract market.

The Commission should not interpret these provisions as applying to contracts that have been defined by the Congress as "gambling" contracts or "wagers." Gambling contracts and wagers are subject to other provisions of law, and it is clear that Congress did not intend for contracts that it has defined as gaming contracts to be subject to the Act. For example, Congress has defined a "bet or wager" in the Unlawful Internet Gambling Enforcement Act of 2006. That Act defines a bet or wager as

> the staking or risking by any person of something of value upon the outcome of a contest of others, a sporting event, or a game subject to chance, upon an agreement or understanding that the person or another person will receive something of value in the event of a certain outcome; [and]
>
> includes the purchase of a chance or opportunity to win a lottery or other prize (which opportunity to win is predominantly subject to chance).

31 U.S.C. Chapter §5362(1). Under this definition, gaming would involve risking something of value on a contest of others, a sporting event or a game of chance. It is unlikely that a contract on an underlying which falls within the definition of "excluded commodity" would also satisfy the Federal definitions of gaming.[14]

It may be that the Commission will not be able to provide clear guidance in advance with respect to every underlying service, right or interest that might be proposed for trading. Many of the current contracts that are trading which the Commission has affirmed as clearly being within its jurisdiction were not foreseen prior to their development. Examples include contracts on crop yields, weather and bankruptcy events. Accordingly, in addition to providing guidance through a safe harbor with respect to the types of factors that distinguish futures contracts from gaming contracts relying upon the above definitions, it may be that the Commission will be required to provide a procedure

[14] The Unlawful Internet Gambling Act on its face makes clear that the definition of "bet or wager" does not include any transaction conducted on or subject to the rules of a registered entity, any over-the-counter derivative instrument or any transaction that is excluded or exempt from regulation under the Act.

by which it can make a determination on a case-by-case basis with respect to novel or complex issues not addressed by the safe harbor.

A case-by-case determination might include a number of factors that the Commission would consider, including the degree to which the contract is expected to be associated with a financial, commercial or economic consequence; whether the potential effects of the event have a consequence beyond the occurrence of the event itself and whether the consequence of the event has a generalized effect for more than the counterparties to the contract. These factors could be considered singly or in combination to determine whether a contract falls within the Act or is effectively a contract that would fall within the Federal definitions of gambling or operate as an equivalent thereto. The Commission may also take into account the trading facility and limitations on access thereto, if any, in determining whether to exercise its exemptive authority under Section 4(c) of the Act in regulating a particular novel or complex instrument.

13. The Commission notes that Section 12(e) of the Act generally provides that the CEA supersedes and preempts other laws, including state and local gaming and bucket shop laws, with respect to transactions executed on or subject to the rules of a Commission-regulated market, or with respect to transactions exempted from the Act pursuant to the Commission's exemptive authority under Section 4(c) of the Act. What are the implications of possibly preempting state gaming laws with respect to event contracts and markets that are treated as Commission-regulated or exempted transactions?

As noted in the question, the Act establishes National standards and a National framework for the regulation and trading of futures contracts and commodity options. This policy has enabled *bona fide* futures contracts to trade under one set of regulatory standards. This policy has enabled futures trading in the U.S. to develop based on uniform National standards and policies. No doubt, this policy has contributed to the successful introduction and widespread acceptance of many of the market innovations fostered by the Commission, including the use of cash settlement.

14. Should certain underlying events or measures--such as those based on assassinations or terrorist activities--be prohibited altogether due to the social perception and impact of such events? What statutory or other legal basis would support this treatment?

CWM at this time does not plan to develop any contracts related to assassinations or terrorist activities.

15. Are there event contracts, such as political event contracts, that should be prohibited from trading under the Act, or that deserve separate treatment or consideration, due to the nature and importance of their outcomes? What statutory or other legal basis would support this treatment?

CWM at this time does not plan to develop event contracts on political campaigns. However, were it to do so, CWM recognizes that special precautions to ensure that the market could not be manipulated would be appropriate in light of the potential importance of such markets.

Legal Implementation

16. Is it appropriate for the Commission to direct certain or all event contracts onto markets that are regulated differently from and perhaps less stringently than DCMs? For example, it may be warranted or necessary to treat event markets that aggregate information solely for academic or research purposes, event markets set-up for internal corporate purposes, or event markets that offer exceedingly low notional value contracts to traders differently than markets that possess the attributes of traditional DCMs.

The Commission should adopt the approach that it first explored in its New Regulatory Framework—providing varying levels of Commission oversight dependent upon the nature of the contracts traded and tiered regulation within an over-all structure permitting market choice. The essence of the regulatory approach adopted by the Commission and enacted by Congress in the CFMA was to establish regulatory requirements that are tailored to the type of products traded and the market participants permitted on the trading facility. The Commission, and Congress in the CFMA, recognized that the choice of tier in which a market operates is a business decision for the market. Thus, the Commission, in proposing its New Regulatory Framework, stated,

> In addition to achieving greater flexibility in their current operations, the exchanges also could choose to operate as a DTF or as an exempt MTEF, where appropriate, and be subject to a lesser degree of regulation for many of the commodities that they trade. Or they could operate a combination the three. The business choice would be theirs.[15]

Using this approach, a market that wishes to permit access to any type of trader and to list any commodity futures contract could do so if it applies for and is granted designation as a contract market. Alternatively, the Commission could create a new market category that restricts the types of contracts listed and the types of traders able to access the market, subjecting the market to fewer regulatory conditions than a designated contract market. This approach would make certain that the Act's goals of ensuring market and price integrity, protecting against market manipulation, protecting the market's financial integrity and protecting customers from abusive trading and sales practices are met.

[15] *"A New Regulatory Framework for Multilateral Transction Excecution Facilities, Intermediaries and Clearing Organizations,"* 65 *Fed. Reg.* 38986, (June 22, 2000)(*"New Framework Rules").*

This approach, modeled after the regulatory framework adopted by the Commission in 2000 and codified in the CFMA, would also make certain that the goals of the Act are achieved in the least burdensome manner and in reliance, to the degree possible, on voluntary submission to Commission oversight. As in 2000, this approach will best assure that the markets have the flexibility to decide how they will meet today's technological and competitive challenges.[16] The flexibility extended to exchanges to make a business decision with respect to the market tier in which they operate is one important reason for the success of the CFTC's regulatory reform model. Some markets have chosen to operate as exempt boards of trade, some as exempt commercial markets and others as designated contract markets. Some operate in more than one tier. However, the choice should properly be left as a business preference of the exchange or market.

A voluntary tiered regulatory framework would be consistent with the Commission's own recommendations for regulatory reform in 2000 as well as with the structure of the Act as codified by the CFMA. The success of the CFMA's regulatory model has been well-recognized and there is no reason why its precepts should not be extended to event contracts. Using this template, certain event markets could operate with less Commission oversight depending upon the nature of the contracts traded, the nature of the participants and whether the market is intermediated.

17. Is it appropriate for the Commission to use the Section 4(c) exemptive authority of the Act for implementing a regulatory scheme for event contracts and markets? In this regard, the Commission notes that it has the discretion to grant an exemption under Section 4(c) to certain classes of transactions without having to make a determination as to whether such transactions are subject to the Act in the first instance.

Some designated contract markets have already listed contracts for trading that might be described as "event" contracts. Although it is appropriate for the Commission to use its 4(c) exemptive authority to implement a regulatory scheme for innovative event contracts, especially contracts that because of their novel or complex nature are difficult to classify under the Act, it is equally important that, by doing so, the Commission not undermine the ability of designated contract markets to list for trading innovative futures products and binary options.

18. Is the issuance of staff no-action relief, such as the relief issued to the IEM, an appropriate or preferable means for establishing regulatory certainty for event contracts and markets? Is a policy statement appropriate or preferable?

In CWM's view, the greatest degree of legal certainty would be provided through the Commission's promulgation of rules governing the conditions that apply to the markets, the operating conditions that apply and the application process. The

[16] See, Staff Task Report at 2.

Commission's implementation of its "New Regulatory Framework" was based, in part, on the Commission's 4(c) authority. Specifically, the Part 37 rules governing application for and operation as a Derivatives Transaction Facility were based on the Commission's section 4(c) authority.[17] A similar regulatory framework would provide applicants choosing not to operate as a designated contract market with clearly delineated conditions that must be met to qualify as an event market, clearly stated operational requirements with which they must comply and clear rules regarding the approval process. It is important that markets and those that trade on them know with certainty the rules under which they operate.

19. What are the benefits and drawbacks of permitting certain event markets to operate pursuant to Commission established conditions that are similar to the conditions under which the IEM operates?

As noted above, CWM develops contracts for listing on designated contract markets. CWM sees no drawbacks in offering markets the choice to operate with certain restrictions with respect to contracts that may be offered and various types of restrictions on market participants subject to a lesser degree of Commission oversight and regulation. As discussed above, however, operating in a restricted, but less regulated environment must be a business choice for the market and not the result of regulatory fiat.

Market Participants

20. Would it be appropriate to allow market participants, and in particular, retail customers, to trade on Commission-regulated event markets with the knowledge that the Commission may not be able to effectively monitor the measures or events that underlie certain event contracts?

Core Principle 3 provides that a designated contract market list contracts for trading that are not readily susceptible to manipulation. For contract markets, this concept might very well include the concept that the pay-out event be objectively ascertainable and transparent. Certainly, to date, contract markets have taken great care in carefully defining the pay-out criteria for those currently listed contracts having event-dependent payouts. In addition to their self-regulatory obligation to meet Core Principle 3, markets can be expected to take care in the definition of the pay-out criteria of the contracts they list as a matter of good commercial practice. To the extent that the Commission has concerns with respect to practices by various markets, it might be an appropriate subject of a statement of acceptable practices.

The Commission could also include such a requirement as a regulatory condition for recognition of a limited trading event market. Requiring the market to certify that its

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[17] New Framework Rules, *supra* at 77968.

contracts meet this standard would negate the requirement that the Commission itself be directly responsible for monitoring the measures or event.

21. What unique protections and prophylactic measures are appropriate or necessary for the protection of retail users of event contracts and markets?

22. What are the implications of permitting the intermediation of event contracts, including intermediation on behalf of retail market participants, both with respect to trade execution and clearing?

23. Are there any types of trader or intermediary conduct, peculiar to event contracts and markets, that should be prohibited or monitored closely by regulators?

The Act provides a number of protections to customers trading in the futures and options markets. These include an anti-fraud protection, appropriate disclosures, segregation of customer funds, rules with respect to prohibited trading practices (such as trading ahead by market intermediaries), and registration of markets and intermediaries. The Commission should consider similar protections for public event markets, tailored to the nature of the contracts and any other limitations that may apply for a market. If a market is not intermediated, certain of the above protections may be required to be provided by the market itself.

If the market chooses to operate as a fully-regulated designated contract market, customers will enjoy all of the customer protections provided under the Act, and few additional requirements would be necessary.

However, one area of customer protection that the Commission may wish to consider is additional disclosure with respect to small-valued contracts. At the time that commodity options were first introduced, the Commission found it appropriate to give close regulatory scrutiny to the offer and sale to customers of deep-out-of-the-money options ("deep-outs"). The Commission believed that the relatively low premiums associated with deep-outs might pose a risk of abusive customer sales practices. Although it is not inherent to event contracts that they be traded in relatively small valued contracts, to the extent that they are, the Commission might wish to consider whether additional disclosures would be appropriate. Of course, this issue is not confined to event contracts.

24. What other factors could impact the Commission's ability, given its limited resources, to properly oversee or monitor trading in event contracts?

There are a number of steps that the Commission could take at the outset to help assure that its resources are used most efficiently. First, any framework that the Commission adopts should incorporate and be based upon the principles of self-regulation. This is the framework for regulation of futures generally, and self-regulatory

requirements, such as requiring a market to self-certify that it is in compliance, and to operate a compliance program appropriate to the nature of the market that will conserve Commission resources. Secondly, adopting rules with well-defined approval processes that take advantage of fast track procedures will also reduce administrative burdens on the Commission. Finally, taking care that the Commission's guidance or proposed rules not discourage contract markets from listing these contracts for trading will also ease potential administrative burdens on the Commission.

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The Commission's Concept Release raises important and timely issues for consideration. The Commission has a long record of encouraging the introduction of innovative futures and option trading vehicles, encouraged by Congress. A number of markets have already introduced novel contracts that are not based on prices for an underlying commodity, but rather are based on other measures, rates or the occurrence of a contingency. The Commission in its consideration of these issues should provide guidance to designated contract markets with respect to novel contracts that clearly fall within the Commission's jurisdiction.

Secondly, the Commission should consider adopting a new market category using the template of the CFMA that enables specialized markets to trade under tailored rules and a tailored degree of Commission oversight. This could be grounded in the Commission's 4(c) authority, as was the Commission's adoption of the New Regulatory Framework prior to its codification by the CFMA. In adopting this framework, the Commission should adhere to the successful template of enabling markets to choose the regulatory tier in which they operate. Finally, the Commission should consider, through a safe-harbor approach, delineating contracts that it views as within the Act from those that it views as outside. In doing so, the Commission should be careful to distinguish single event contracts from other types of indexes or contracts that might be constructed in the same industry or economic sector. Finally, the Commission should include a procedure for making determinations with respect to novel or complex contracts that are not addressed by the safe harbor.

Event contracts are an exciting new form of futures trading that have the potential to offer risk shifting opportunities to entirely new areas of the economy, as well as to disseminate price information concerning new areas of endeavor. CWM commends the Commission for its vision in seeking to address the issues that are raised by this relatively new market phenomenon and CWM looks forward to participating in the future growth of these markets.

Respectfully submitted,

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