

THE FEDERAL REGULATION OF POLITICAL EVENT CONTRACTS

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I. **Event Contracts Defined**

A financial agreement linked to, or the value of which is derived from, an occurrence, extent of an occurrence, measure, event or contingency beyond the control of the parties to the relevant contract, agreement, or transaction.¹

Political Event Contracts are event contracts tied to the results of elections or other political outcomes. They are often structured as binary options which typically pay out a fixed amount when an outcome either occurs or does not occur.

II. **The Dodd-Frank Act**

After the financial crisis of 2008-2009, Congress placed specific limitations on the listing of event contracts.

Section 745 of the Dodd Frank Act, entitled "Enhanced Compliance by Registered Entities," added a new provision to the Commodity Exchange Act, Section 5c(c)(5)(C)

"Special rule for review and approval of event contracts and swaps contracts," specifically addressing event contracts. That section provides:

(i) Event contracts.--In connection with the listing of agreements, contracts, transactions, or swaps in excluded commodities that are based upon the occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or levels of a commodity described in section 1a(2)(i)), by a designated contract market or swap execution facility, the Commission may determine that such agreements, contracts, or transactions are contrary to the public interest if the agreements, contracts, or transactions involve—

¹ Commodity Modernization Act, Definition of Excluded Commodity; 28 Pub. L. No. 106-554, 114 Stat. 2763 (2000). Concept Release on the Regulatory Treatment of Event Contracts, 73 Fed. Reg. 25669 (CFTC May 7, 2008).

- (I) activity that is unlawful under any Federal or State law;
 - (II) terrorism;
 - (III) assassination;
 - (IV) war;
 - (V) gaming;
 - (VI) other similar activity determined by the Commission, by rule or regulation, to be contrary to the public interest.
- (ii) Prohibition.--No agreement, contract, or transaction determined by the Commission to be contrary to the public interest under clause (i) may be listed or made available for clearing or trading on or through a registered entity.

III. **CFTC Regulation 40.11**

Pursuant to Section 5c(c)(5)(C), the Commission promulgated Regulation 40.11.

Regulation 40.11(a) provides that

A registered entity shall not list for trading or accept for clearing on or through the registered entity any of the following:

- (1) event contract that involves, relates to, or references terrorism, assassination, war, gaming, or an activity that is unlawful under any State or Federal law; or
- (2) An event contract that involves, relates to, or references an activity that is similar to an activity enumerated in subsection (1) of this part, and that the Commission determines, by rule or regulation, to be contrary to the public interest.²

In addition, Regulation 40.11(c) creates a 90-day review period during which the Commission may determine whether a futures or swap contract proposed to be traded by an exchange may violate Regulation 40.11(a).

Note that while the Dodd Frank Act *permits* the CFTC to determine that certain event contracts are contrary to the public interest, Regulation 40.11 prohibits an exchange from listing event contracts tied to the enumerated events.

² 17 C.F.R. Sect. 40.11.

IV. Exchange Trading of Political Event Contracts

A. The North American Derivatives Exchange (NADEX):

In December 2011, NADEX sought to trade a series of political events contracts related to the results of the U.S. federal elections in 2012. On April 2, 2012, the CFTC issued an order that prohibited NADEX from listing the relevant political event contracts, having determined that the contracts involved “gaming” and were contrary to the public interest under Section 5c(c)(5)(C) of the CEA. The CFTC order pointed to the connection between the terms “gaming” or “gambling” to betting on elections, and noted that state gambling definitions of “wager” and “bet” are “analogous to the act of taking a position” in political event contracts. The CFTC also noted that the proposed contract could not reasonably be expected to be used for hedging purposes and have no price basing utility. Therefore, they fail the “economic purpose” requirement and are contrary to the public interest. Finally, the Commission notes that the contracts could be used in ways that would have an adverse impact on the integrity of elections.³

B. Victoria University of Wellington, New Zealand (Predictit)

In October 29, 2014, the CFTC’s Division of Market Oversight issued a no action letter allowing Victoria University of Wellington, New Zealand (“Victoria University”) to operate a small scale political event contract market offering political event contracts to U.S. persons, without registering with the CFTC as a regulated exchange. Pursuant to CFTC Letter 14- 130, Victoria University indicated that the information gathered through trading of the contracts would be used for educational and research purposes, and the no action letter stated that the University operate the market as a not-for-profit, that to keep the market small scale traders would have a position/investment limit of only \$850 per contract and a limit on the number of traders.⁴

A similar academic market had been operated by University of Iowa since the early 1990s pursuant to a CFTC Division no action letter.⁵

C. Kalshi

In July, 2022, a CFTC registered exchange sought approval from the CFTC to list a series of political event contracts based on election results. Kalshi argued that the relevant contracts did not reference gaming nor any unlawful activity. They also argued that the relevant contracts could be used to hedge economic and commercial consequences of elections, while not threatening the integrity of U.S.

³ CFTC Order Prohibiting the Listing or Trading of Political Event Contracts, In re Self-Certification by North American Derivatives Exchange, Inc. of Political Event Derivatives Contracts and Related Rule Amendments under Part 40 of the Regulations of the Commodity Futures Trading Commission (April 2, 2012).

⁴ See Vincent McGonagle, CFTC No-Action Letter 14-130 (October 29, 2014)

⁵ See Andrea M. Corcoran, CFTC No-Action Letter rf05-003 (June 18, 1993)

elections. Kalshi also pointed to the fact that other similar political event contracts were permitted to be offered to persons in the U.S. on platforms that were not regulated exchanges and instead operated pursuant to no action relief.⁶

The CFTC stayed the listing of the contracts pending review and sought public comment.⁷ Over 200 comments were received. The CFTC has yet to take action either to approve or disallow the Kalshi contracts.

D. Victoria University/Predictit: Revocation of No Action Relief

In August, 2022, the CFTC Division of Market Oversight revoked its no action letter to Victoria University claiming it was not complying with the conditions of the no action letter. The exchange operator, traders and others sued to prevent the CFTC from shutting down the exchange. In July of this year the U.S. Court of Appeals for the Fifth Circuit issued a preliminary injunction against the CFTC preventing it from rescinding its no action relief. Among other things, the Court found that the CFTC had been arbitrary and capricious in not providing sufficient explanation as to Predictit's alleged non compliance and for failing to provide the exchange an opportunity to cure any alleged deficiencies.

V. **Among the Issues Raised by Political Event Contracts**

- Does the Commodity Exchange Act require that contracts have an “economic purpose”? If so, do political event contracts provide a legitimate hedging and price basing function?
- Does speculating on elections constitute gambling? And if so, should that foreclose such trading?
- Should the fact that some states still prohibit betting on elections be dispositive under federal law?
- Is the risk to the integrity of elections significant? How difficult would it be to monitor and mitigate those risks?
- Does the CFTC have the resources to oversee election trading? Would this oversight function be better placed elsewhere in the federal government?

⁶ See KalshiEX LLC - Commission Regulation 40.3(a), Voluntary submission of new products for Commission review and approval (July 19, 2022)

⁷ See Press Release, CFTC Release No. 8578-22, CFTC Announces Review and Public Comment Period of KalshiEx Proposed Congressional Control Contracts Under CFTC Regulation 40.11 (Aug. 26, 2022)