KPMG

Regulatory Alert

Regulatory Insights

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Prediction Markets: CFTC Proposal on Public Interest Determinations

KPMG Regulatory Insights:

Growing Markets: *"Significant increase" in the number of event contracts listed for trading on prediction markets, as well as in the diversity of events underlying such contracts. Particular interest in "gaming" contracts.*

Clarifying Scope: *Proposal seeks to clarify the scope of permissible contracts—those that are in the public interest—through many examples. However, potential for contracts ultimately found to be contrary to the public interest could still be listed for trading before a final determination is made.*

Jurisdictional Issues: *Ongoing federal/state jurisdictional disputes/lawsuits and state enforcement activity; potential for federal legislation.*

Future Rulemaking: *Additional rulemakings may address DCM Core Principles, the treatment of swaps and futures contracts similar to event contracts that are not listed on DCMs, or the application of the CEA and CFTC regulations to blockchain-based prediction markets.*

The Commodity Futures Trading Commission (CFTC) has issued a proposed rule that would amend its regulations for event contract derivatives, which are offered for trade on markets commonly referred to as "prediction markets."

The proposed amendments, including a new Appendix F, would establish a structured framework for determining whether an event contract "involves" an activity identified in the "Special Rule" (i.e., Section 5c(c)(5)(C) of the Commodity Exchange Act (CEA)), including terrorism, assassination, war, gaming, or conduct that is unlawful under federal or state law, and, if so, whether the contract is contrary to the public interest. In particular, the amendments would address the:

- Scope of the Special Rule.
- "Three-step inquiry" to evaluate event contracts under the Special Rule.
- Clarification of "gaming", including defined terms and considered factors.
- Process for CFTC review and determination.

The proposed rule follows an Advisory and advanced notice of proposed rulemaking (ANPR) covering the responsibilities of designated contract markets (DCMs) when listing and trading event contracts (see KPMG Regulatory Alert, here).

Separately, in actions prompted by the increase in sports-related gaming contracts, the CFTC entered into Memorandums of Understanding with both Major League Baseball and the National Hockey League, providing a mechanism for the CFTC and the professional sports leagues to share information to help protect the integrity of the sports and the related prediction markets (e.g., emerging trends related to fraud or manipulation.)

Most recently, the CFTC issued an advisory to remind DCMs about the procedures to submit self-certifications of an event contract series. The advisory addresses that DCMs should not submit "broad, template-style certifications" and details requirements for certification, including pricing sources, formulas, procedures, and methodologies for calculating reference prices and payment obligations. The CFTC also states when closely related event contracts may be certified as a class.

Scope of the Special Rule

The Special Rule - Section 5c(c)(5)(C) of the Commodity Exchange Act - authorizes the CFTC to prohibit event contracts involving unlawful activity, terrorism, assassination, war, or gaming (collectively, enumerated activities), or any comparable category that the CFTC identifies by rule or regulation as contrary to the public interest. CFTC Regulation 40.11 implements this authority by barring registered entities (i.e., DCMs) from listing or clearing contracts involving the prohibited categories – effectively barring all contracts involving these activities. The CFTC has not identified any other comparable category besides those explicitly listed in the Special Rule.

Under the proposed rule, the CFTC would introduce a new three-step inquiry process to assess whether a contract is within the scope of the Special Rule, including whether it is contrary to the public interest. The inquiries would be conducted on a contract-by-contract basis, where the CFTC would be required to affirmatively determine that a contract is contrary to the public interest. The proposed rule, including Appendix F, would offer numerous examples of factors that may influence whether an event contract involves an enumerated activity or is contrary to the public interest.

Three-Step Inquiry

The proposed rule would require the CFTC to conduct a "three-step inquiry" before prohibiting an event contract under the Special Rule. For each contract, the CFTC would determine whether:

- ***First*** - The instrument (an agreement, contract, transaction or swap in an excluded commodity) qualifies as an event contract (i.e., is "based upon an occurrence, extent of an occurrence, or contingency.")
- ***Second*** - The contract settlement "involves" an enumerated activity (i.e., unlawful activity, terrorism, assassination, war, gaming) or another similar activity identified by CFTC rule or regulation.
  - **"Involves an activity"**, for this purpose, is proposed to mean when the settlement of an agreement, contract, transaction, or swap is determined by an occurrence, extent of an occurrence, or contingency in that activity. The proposed rule would also include separate provisions outlining factors for determining involvement of enumerated activities.
- ***Third*** - If the contract is an event contract and involves an enumerated or similar activity, then whether it is contrary to the public interest. **Factors** to be considered would include the potential:
  - **Utility** of the contract, including meaningful hedging, price-basing or information value, or benefits to responsible innovation and fair competition.
  - **Risks** presented by the contract, including manipulation, market disruption, settlement integrity deficits or the leakage or exploitation of material nonpublic information by insiders.
  - **Challenges** to prediction market self-regulatory tools or compliance infrastructure, including surveillance, customer identification, trading restrictions, dispute resolution and other functions.
  - **Specific concerns** unique to the type of enumerated activity, such as incentives for unlawful conduct under federal and/or state law; national security risks or human safety risks associated with terrorism, assassination or war; or the outcome of games that depend entirely on random chance.

Clarification of "Gaming"

The proposed rule would define **"gaming"** as "any activity that:

- One or more participants typically engage in for purposes of recreation or to entertain others;
- Is governed by rules; and
- Includes measurable occurrences or outcomes that depend on the participants' luck, skill, or athletic ability during the activity."

Acknowledging a wide variety of listed event contracts based on sports activities, the proposed rule would outline factors that the CFTC would consider when determining if an event contract based on a sports activity is contrary to the public interest. The CFTC indicates that no single factor would decide whether a contract is contrary to the public interest and that it would consider all relevant factors for each contract.

Sports Contracts	
Factors Against… a finding that a sports event contract is contrary to the public interest would include:	**Factors Favoring…** a finding that a sports event contract is contrary to the public interest would include those with a settlement based on:
— Settlement based on the overall outcome of a professional or collegiate sporting event, including a final score, point differential, win-loss result, tournament advancement, individual or team statistical performance, or season-long performance. — Objective and verifiable settlement data, including data reported publicly, verified by a sports league or confirmed through another objective source. — Established sport-level integrity infrastructure, including a recognized governing body, integrity unit or monitoring function, published competition rules and disciplinary procedures. — Safeguards for the prediction market, including trading surveillance and restrictions to prevent insider trading. — Information sharing and coordination with sports leagues, governing bodies, and sports-integrity organizations, including consultation on proposed contracts, and cooperation on investigations of suspicious trading.	— A specific action controlled by a participant or team including a particular play, pitch, shot, foul or penalty. — A physical altercation or other conduct that could result in a penalty, ejection or disciplinary action. — An injury to a specific athlete, including the occurrence, duration, severity or medical diagnosis of the injury. — A decision by an official, including a penalty, foul, review, replay decision, ejection or disciplinary ruling. — The outcome of a pre-collegiate sporting event, including an event involving minors, or a sport that otherwise lacks the integrity protections used in professional and collegiate sports.

Process for Determinations – Submission and Review Procedures

The proposed rule would establish a 90-day process for CFTC review of event contracts that may be subject to the Special Rule. The process would include:

- ***Submission of an Event Contract for Approval:*** The registered entity may submit an event contract through self-certification or request CFTC approval of the contract. The submission must include an analysis of whether the event contract involves an activity identified in the Special Rule and, if so, why the contract is not contrary to the public interest.
- ***Review of an Event Contract*:** Within 10 days after the self-certified listing, the CFTC may initiate a 90-day review by providing the registered entity with a written determination that there is a basis to believe the event contract is contrary to the public interest. The CFTC may request the registered entity suspend the listing or trading of the event contract pending the review period. The determination must identify the contract under review, the activity involved, the relevant contract terms, and the public interest factors at issue.
- ***Pre-Decision Statement:*** Within 15 days after the registered entity receives the written determination, the Director of the Division of Market Oversight must provide it with a written statement identifying the factual basis, legal theory, specific contract terms, and factors supporting the review.
- ***Responses by the Prediction Market:*** The registered entity may submit a written response within 30 days after receiving the written determination. The response may include supporting data, expert submissions, economic analysis, and proposed contract modifications.
- ***Recommendation:*** No later than 60 days after initiating the review, the Director, with the concurrence of the General Counsel, may submit a written recommendation to the CFTC and the registered entity regarding the CFTC determination. The registered entity may submit a written response, limited to the recommendation, by day 70.

- ***CFTC Orders:*** No earlier than 90 days after the written determination initiating the review, or at the conclusion of any extension agreed to by the registered entity, the CFTC may issue an order finding the contract contrary to the public interest. The order must address the factors on which the CFTC relied, weigh the factors for and against listing, and explain whether the determination is consistent with previous decisions involving comparable contracts. If the CFTC does not issue an order, or if more than 100 days have passed since the listing of the contracts subject to review, the contracts may continue to be listed for trading.
- ***Delegated Functions:*** The Director of the Division of Market Oversight or a designee would have authority to serve notices, written determinations, and statements during the review and develop staff recommendations. The CFTC would retain authority to initiate the review and issue the final determination.

The CFTC anticipates that, in some instances, a determination that an event contract is contrary to the public interest might require an event contract that is actively trading to be delisted. Registered entities are encouraged to engage with CFTC staff to discuss event contracts that may involve enumerated activities and may raise concerns based on the factors proposed. The CFTC states that such discussions prior to self-certification could mitigate adverse consequences from trading of event contracts that are later prohibited under the Special Rule.

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