The Current State of Prediction Markets

Prediction markets burst onto the American marketplace in the fall of 2024, and their popularity has only grown since[1,2]. While these markets have existed in the U.S. for decades, their use expanded rapidly last year after KalshiEX LLC (Kalshi), a federally regulated derivatives exchange and clearinghouse, began offering contracts based on the outcome of political events (*e.g.*, "Will Trump win the White House")[3]. The Commodity Futures Trading Commission (CFTC) under the Biden Administration sought to prohibit such contracts, arguing that they were akin to gaming and contrary to the public interest; however, Kalshi sued the CFTC in court and won[4,5].

Since Kalshi's 2024 legal victory, prediction markets have expanded to offer event contracts based on crypto, climate, economics, financials, companies, and—most controversially—sports. Entrenched incumbents, including gaming associations, Tribal nations, and the States, have filed lawsuits and cease-and-desist letters to protect what was traditionally their domain[6,7,8]. Other industry participants, however, have sought to capitalize on opportunities they've identified:

- Polymarket recently purchased CFTC-registered QCX for $112mn[9,10,11],
- Railbird Exchange, another competitor, is preparing for its launch[12,13],
- Novig, a state-regulated sweepstakes platform raised $18MM eyeing CFTC registration[14,15]
- Robinhood and Webull announced partnerships with Kalshi to offer event contracts to its customers[16,17], and
- FanDuel has partnered with CME Group to launch new products and expand into the financial derivatives market[27].

With much influx in the world of prediction markets, this article shares our insights on emerging opportunities and risks for markets participants.

What is an Event Contract?

An event contract is a type of swap, structured with a binary outcome of "yes" or "no". These contracts provide payoffs based on the occurrence or non-occurrence of specific events that have commercial, financial, or economic consequences, such as economic indicators, company performance, financial markets, election results, weather outcomes, sport competitions, and other measurable events. The Commodity Exchange Act (CEA) has a list of enumerated topics which gives the CFTC the ability to prohibit such contracts; "gaming" is included as an enumerated category and therefore the CFTC may prohibit contracts based on it if the CFTC determines such contracts are "contrary to best interest" of the public[18,19,20,25,26]. Of all the potential underlying events, contracts with political and sports-based outcomes have sparked the most controversy, though for distinct reasons. Critics claim that political-based contracts have the ability to distort elections and sports-based contracts may be exploited as a way to circumvent state-level gambling provisions and effectively make "sports betting" *legal* in all 50 states in addition to opening markets to bettors starting at a younger age (18 rather than 21).

Emerging Opportunities and Risks

Traditional Gaming Industry:

Sportsbook industry reactions have been diverse and at times inconsistent. In recent months, event contracts have blurred the line between financial trading and gambling. This in turn has led firms to identify new opportunities for the traditional gaming industry, most notably sportsbooks and fantasy sports platforms. Leading sportsbook operators are actively evaluating how to become regulated by the CFTC, enabling them to offer event contracts. These firms are considering three primary routes:

1. Registering with the CFTC as a designated contract market (DCM) and/or designated clearing organization (DCO), a process that is rigorous and time-intensive;
2. Registering as an introducing broker (IB), which is quicker but requires partnering with a CFTC registered DCM/DCO for contract execution and clearing; or,
3. Acquire or partner with a CFTC registered DCM/DCO which may or may not already offer event contracts.

For gaming companies, event contracts represent a chance to attract and retain customers across all 50 states. It may also allow them access to the increase in retail trading over the past five years. It's also worth noting that the trading v. gambling distinction carries direct bottom-line implications through tax treatment; for example, whether CFTC-regulated event contracts are subject to the federal excise tax on wagers under 26 U.S.C. § 4401 depends on classification as a 'wager' under § 4421; authoritative guidance specific to CFTC event contracts is unsettled. Additional state-level tax nuances and varying information reporting requirements can also apply, depending on how the activity is classified[21,22,23,24].

Banks, IBs, B/Ds, and Asset Managers:

The traditional financial services industry has two key aspects of prediction markets to consider:

1. How to surveil employee trading, and
2. Whether to allow clients to trade on event contracts through brokerage accounts.

Control Room Surveillance – Our clients have expressed concerns regarding the use of material non-public information (MNPI) in prediction markets, which pose a substantial threat beyond the integrity of these markets and onto the firms and individuals themselves. To protect their reputation, comply with regulatory requirements, and uphold the highest standards of ethical conduct, financial service firms should consider proactive measures to identify, mitigate, and prevent such risks. Specific risks and challenges include **exploitation of sensitive information** as employees with access to MNPI misuse it to enter into event contracts, predicting outcomes of financial events; **market distortion**, including insider-driven trades impacting market integrity; and **regulatory and legal consequences**, if controls and safeguarding are insufficiently designed to prevent misuse of MNPI, including regulatory action, fines, and reputational damage.

Offering Event Contracts to Retail Consumers (e.g. Banking App interface) – Consumer appetites are evolving and driving growing retail demand for unconventional assets, leading some financial service firms to identify event contracts as an attractive new offering. While current media coverage is focused on more *controversial* events (*e.g.*, sport and political outcomes), events in the financial industry, such as company earnings and Fed rate decisions, may give consumers further methods to enhance their portfolios. From the banks' perspective, offering these capabilities could deepen client relationships – showing they can attempt to innovate and respond to client pain points and demand. By leveraging their trusted platforms, banks may attempt to capitalize on opportunities they identify, either by partnering with established DCM/DCO platforms or by using their own trading capabilities. For an example of partnership structure, a firm may reference Robinhood's partnership with Kalshi to offer its customers access to prediction markets through brokerage accounts[16].

Traditional Derivative Exchanges:

For established derivative exchanges and trading venues, the rise of event contracts offers both a growth opportunity and a strategic challenge. Opportunities include:

1. Offering event contracts, thus increasing product and client diversity.
2. Adapting to markets with heavier retail participation and opening new industries for partnerships.

Event contracts provide an opportunity for traditional exchanges to diversify their offerings beyond standard asset classes. These contracts can appeal to retail traders thanks to their intuitive yes/no format, potentially attracting participants who find trading traditional futures or options too complex. Additionally, there could be potential for partnerships with traditional sportsbooks, possibly allowing exchanges to integrate sports trading (betting) to reach a broader retail audience.

The incorporation of event contracts could diversify product offerings and attract new revenue streams, yet it poses challenges in defining risk parameters traditionally managed within established derivatives risk management frameworks. Event contracts, with their discrete outcomes, challenge traditional risk models that are designed for continuous market variables, making it difficult to predict price movements using standard metrics. Additionally, the lower liquidity in these markets leads to more volatile bid-ask spreads and unpredictable pricing, complicating the accurate calibration of risk measures like margin requirements. To effectively manage these risks, firms could start by developing innovative risk models that integrate advanced analytics with fresh insights and potential new regulatory guidance tailored to the unique dynamics of event contracts.

KPMG Approach

We support our clients as they navigate CFTC and SEC regulatory requirements, including advising on requirements and expectations, preparing cost/benefit analyses and gap assessments, designing and uplifting compliance, risk management, and surveillance frameworks, and preparing for registration. Our team of former regulators and industry professionals understands the derivatives regulatory environment and many of the practical needs of firms in the market.

Whether you're a sportsbook, financial institution, or derivative exchange, we can provide tailored strategic consulting on market entry, financial product design (incl. implementation and subsequent reporting requirements), and operational partnerships, enabling you to capitalize on emerging opportunities and manage risk.

Connect with us to explore how we can support your firm in navigating the evolving event contract landscape.

Third-party entities are referenced for identification and context only. No endorsement is implied.

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Statutes & Regulations

[18] 7 U.S.C. § 7a-2(c)(5)(C) — Event contracts special rule (enumerated topics incl. "gaming").

[19] 17 C.F.R. § 40.11 — Review of event contracts; prohibitions and 90-day review.

[21] 26 U.S.C. § 4421 — Definitions ("wager").

[22] 26 C.F.R. § 44.4401-1 — Imposition of tax (procedural/regulatory explanation)

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