



# Gaming and regulation of events contracts



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# Overview

- CFTC authority to review event contracts
- State gambling laws and the Murphy decision
- History of CFTC's authority to review futures contracts
- The CFTC's application of its review authority to event contracts
- Recent CFTC enforcement matters involving event contracts and binary options
- SEC Regulation of Gaming Contracts
- FinTech developments in prediction markets
- Looking ahead



# Definitions

**“Gaming”** – staking of money on the result of a game of pure chance, or mixed skill and chance, e.g., casino, poker (referred in Rule 40.11(a)(1), and CEA § 5c(c)(5)(C)(v), § 12(e)(2) together with “bucket shops”)

**“Gambling”** – same as gaming, but historically with a suggestion that the stakes are excessive or the practice otherwise is reprehensible; States usually have Anti-Gambling Acts

**“Wagering”** – refers to money hazarded on any contingency in which the person wagering has no interest at risk other than the amount at stake

**“Betting”** – is usually restricted to wagers on sporting events, horse races or games generally (referred in Murphy)

**“Event contracts”** – contracts in excluded commodities based upon occurrence, extent of occurrence, or contingency (other than change in price of a commodity) CEA § 5c(c)(5)(C)(v)

**“Binary options”** – “a type of option whose payoff is either...fixed...or zero”, i.e., is exercised upon yes / no occurrence (CFTC glossary); event contracts usually take the form of binary options

**“Excluded commodity”** – intangible rates, indices, measures, as well as occurrences or contingencies beyond control of the parties and associated with financial, commercial or economic consequence (§ 1a(19) of the CEA)



# CFTC Authority to Review Event Contracts



- Under longstanding CFTC rules, a designated contract market (DCM) can list new products by one of two methods.
  - Self-certification (CFTC Rule 40.2); Commission review and approval (CFTC Rule 40.3)
- As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Congress gave the CFTC special authority to review “event contracts.”
- CEA § 5c(c)(5)(C) authorizes the CFTC to prohibit futures, options or swaps on an excluded commodity that involves terrorism, assassination, war, gaming, unlawful activity (under state or federal law) or other “similar activity” if the Commission determines that the contract is “contrary to the public interest.”



# CFTC Authority to Review Event Contracts *(Continued)*

- CFTC adopted a regulation in 2011 to implement its new authority.
- CFTC Rule 40.11 outright prohibits the types of contracts based on the activities identified in the statute.
- Rule provides for a 90-day review period for contracts that the Commission determines “may involve, relate to, or reference” one of the activities identified in the statute.
- Rule requires the Commission to request suspension of trading during the review period.
- Rule provides that the Commission must approve or disapprove the contract within the 90 days or an agreed upon extended period.



# CFTC Authority to Review Event Contracts *(Continued)*

- In adopting the rule, CFTC acknowledges that term “gaming” requires “further clarification” but defers that to possible future rulemaking. Also defers identification of activities “similar to” those enumerated in statute.
- CFTC notes that prohibition of gaming contracts is consistent with Congress’s intent to “prevent gambling through the futures markets.”



# State Regulation of Gaming Contracts

States for centuries enacted laws prohibiting gambling.

- In 1638 the Puritans of Massachusetts enacted America's first law against gambling. It was based on the Idleness Statute of 1633 which outlawed the possession, even in one's home, of cards, dice, and gambling devices.

In fact, the Board of Trade v. Christie Grain (U.S., 1905) sued a bucket shop under Illinois State gambling law. Court's approach eventually became the 1922 Grain Futures Act – requiring trading of futures to be only on registered exchanges.

- Christie Grain also introduced public policy / interest considerations that distinguish legitimate derivatives from gambling and wagering and is now in CFTC Rule 40.11.

Since then, derivatives received U.S. federal protection (subsequently CFTC federal preemption in CEA § 12(e)(2)) while the States continued enforcing their anti-gambling laws.





# The Murphy Decision

Professional Amateur Sports Protection Act of 1992 (PASPA) prohibited States from allowing sports betting, with very few exceptions (such as for preexisting State laws – e.g., Nevada). The State of New Jersey, desiring to develop its Atlantic City business sued to repeal PASPA on constitutional anti-commandeering grounds.

In 2018, the U.S. Supreme Court repealed the PASPA in Murphy v. NCAA (138 S.Ct. 1461) as unconstitutional violation of state rights. Its implications are:

- States are free to enact laws to allow sports betting;
- States' gambling laws are still in place;
- The Federal Wire Act of 1961 still prohibits *interstate* wagering and betting, including on sports events;
- Murphy does not supersede application of other federal laws (e.g., CEA or the Wire Act);
- States already test the waters to expand Murphy to other event and betting markets;
- Court's anti-commandeering language can be taken to other State laws relating to other commodities, such as cannabis (if indeed it and its related products are a commodity).

As of the end of 2021 – more than ½ of States legalized sports betting, and other States are considering the same.



# History of CFTC Authority to Review Futures Contracts

- The “public interest” determination called for by CEA § 5c(c)(5)(C) is informed by the history of the CEA.
- Statute establishing the CFTC gave the agency authority to review *every* futures contract to determine whether a DCM “demonstrate[d]” that the contract “will not be contrary to the public interest.”
- Legislative history made clear that the public interest included an economic purpose test for the contract – “something more than occasional use . . . for hedging or price basing must be established.”
- CFMA in 2000 eliminated the CFTC’s broad authority to review and block listing of futures contracts by giving DCMs the ability to self-certify that contracts comply with the CEA.



# CFTC's Treatment of Event Contracts

- University of Iowa 1993 no-action relief for non-profit electronic market for binary contracts involving political events and economic indicators.
- Victoria University of Wellington 2014 no-action relief for non-profit electronic market for trading binary contracts involving political events and economic indicators.
- CFTC first invokes Rule 40.11 review process in response to Nadex self-certification of political event contracts at the end of 2011.
  - CFTC determines that Nadex contracts involve gaming, noting that many state statutes equate gaming or gambling with betting on elections.
  - CFTC also determines that the political event contracts are contrary to the public interest because they have neither hedging nor price basing utility and could have adverse effect on elections. (Commission applied original public interest test, observing that Congress “inten[ded] to restore” it after its deletion in the CFMA.)



# CFTC's Treatment of Event Contracts - ErisX

- In Dec. 2020, ErisX self-certified futures contracts on various outcomes (moneyline, point spread, total points) of NFL football games.
- Contracts structured like binary options with winning position receiving settlement price of \$100 and losing position receiving settlement price of \$0. Contracts would be fully collateralized and only available to ECPs.
- ErisX submission emphasizes hedging purposes – contends sportsbook operators hold unbalanced books arising from in-state customers favoring home team. Also asserts that stadium owners and vendors have need to hedge against poor attendance.



# CFTC's Treatment of Event Contracts – ErisX

*(Continued)*

- CFTC determined that NFL contracts triggered Rule 40.11 review.
- ErisX withdraws submission one day before review period would have expired.
- Despite absence of Commission order, two (now former) Commissioners issue statements about ErisX's submission.
- Former Commissioner Quintenz discloses content of proposed order and criticizes it. Expresses concerns about:
  - the statute itself, which he claims gives too much discretion to agency
  - the regulation, which is a per se prohibition of contracts involving the activities identified in the statute
  - the proposed order's placing of burden on the DCM to prove hedging function



# CFTC's Treatment of Event Contracts – ErisX

*(Continued)*

- Former Commissioner Berkovitz would have blocked the NFL contracts' listing.
  - Determines that contracts involve “gaming”
  - Concludes that ErisX did not provide sufficient evidence that contracts would provide an effective hedging mechanism (so doesn't satisfy public interest test)
  - Also finds that contracts, by restricting trading to ECPs, violate two DCM core principles, CP 2 (impartial access to market); and CP 19 (antitrust)



# CFTC Enforcement Actions Against Event Contracts

## Previous enforcement actions:

- CFTC v. Ronald Montano and Montano Enterprises LLC (2018)
- CFTC v. Yehuda L. Belsky and Y Trading, LLC (2019)
- BigOption, BinaryBook, and BinaryOnline (2019)
- CFTC v. CIT Investments LLC, Brevspand EOOD, CIT Investments Ltd., CIT Investments Ltd., and A & J Media Partners, Inc. (2019)
- CFTC v. Peter Szatmari (2020)
- CFTC v. Daniel Fingerhut, Itay Barak, Tal Valariola and Digital Platinum Limited (2021)

CFTC's Binary Options Customer Fraud Advisories and "RED" List



# SEC Regulation of Gaming Contracts

The threshold issue – whether there is a “security” involved, and the common form of security is an “investment contract” under Howey Test.

- For example, in Sept. 2020, the SEC issued a cease-and-desist order to Unikrn, Inc, an operator of an online eSports gaming and gambling platform (SEC File No. 3-20003, In re Unikrn, Inc.).
- Unikrn issued digital tokens that allowed participants to, among other things, “place bets on professional eSports and video game matches...” Subsequently, it started to issue tokens to raise money “to power the most immersive live-betting platform for eSports.”
- SEC found that Unikrn issued securities (*i.e.*, investment contracts) without registration under § 5(a) of the Securities Act.





# SEC Regulation of Fantasy Sports Contracts

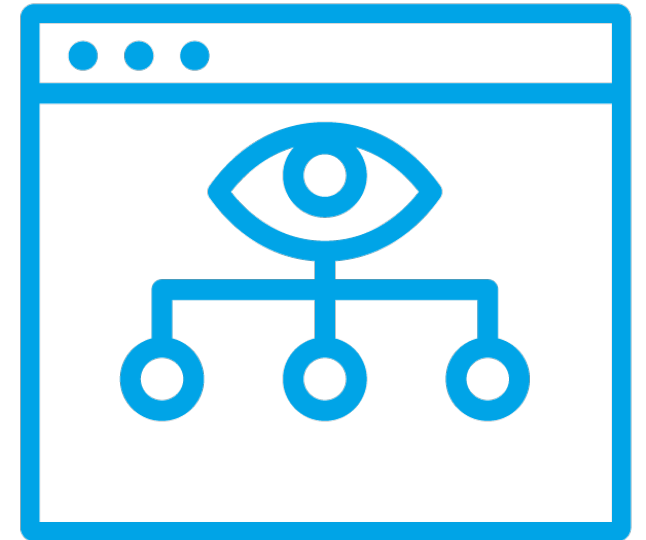
The other SEC-jurisdictional nexus is whether trading involves “security based swaps” (SBS) and whether offered to non-ECPs.

- In re Forcerank, SEC File No. 3-17625 (Oct. 2016), the SEC sanctioned Forcerank for illegally offering complex derivatives products to retail (non-ECP) investors through mobile phone games that were described as “fantasy sports for stocks.”
- The SEC stated that Forcerank’s agreements with players were SBS because they provided for a payment that was dependent on an event associated with a potential financial, economic, or commercial consequence and based on the value of individual securities.
- The contracts were not registered and not traded on an exchange and not offered to ECPs. Similar SEC cases were Sand Hill Exchange (June 2015), and TradeNet Capital Markets (Oct. 2020)

# SEC's Focus

In sum, SEC also focuses on gaming and gambling issues, but from a different, more technical perspective than the CFTC –

- Whether an unregistered securities offering is taking place or whether non-ECPs are participating in the trading of SBS.
- If contracts in all of these cases were properly registered, traded on national exchanges or with respect to SBS offered to ECPs, there will have been no violation of securities laws.





# FinTech Developments and Implications

**In 2018 Augur listed contracts that are bets on political and other assassinations.**

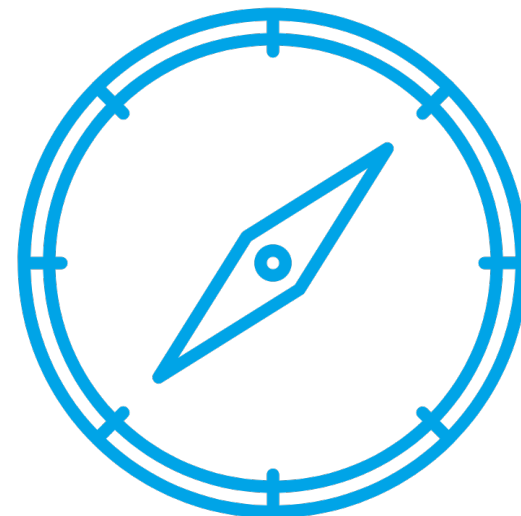
- Augur lists smart contracts on Ethereum, a blockchain network that is not controlled by any single party (decentralized finance “DeFi”); the contract is executed when a real-world event happens and is confirmed.
- The developers gave up control over the platform so no individual can control it. Augur describes itself as: “Your global, no-limit betting platform, Bet how much you want on sports, economics, world events and more.”
- Eventually, Augur participants delisted assassination contracts (voluntarily).
- Polymarket is a similar DeFi Ethereum platform launched in 2020 that allows binary options contracts exercisable under yes / no conditions.

## **Questions remain:**

- how the CFTC will react to these decentralized markets in the future if there is no control over a venue where the contract trades;
- how the CFTC will assess the public interest of these markets; and
- legality generally if the States legalize these betting venues and the underlying commodities (e.g., cannabis).

# Looking Ahead

- Points made by former commissioners illustrate that there are many challenging issues for the Commission in deciding whether and how to approve an event contract.
- Will ErisX resubmit?
- How will new Commission approach event contracts?
- With prediction markets continuing to grow, expect further developments with respect to the CFTC's treatment of event contracts.





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The image features the letters 'FIA' in a bold, sans-serif font. The 'F' is dark grey. The 'I' is dark grey with a green triangle on its right side. The 'A' is composed of a green triangle on the left and a blue triangle on the right. The background is a white canvas with large, overlapping geometric shapes in light green, light blue, and yellow.