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NFL futures contracts and the future of contracts that may involve 'gaming'

By Jonathan Marcus, Esq., Reed Smith

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The withdrawal by ErisX on March 22, 2021, of its submission to the Commodity Futures Trading Commission ("CFTC" or "Commission") to list cash-settled futures contracts on National Football League games ("NFL contracts") will not be the last word on the subject of derivatives contracts on sports events, much less on prediction contracts more generally.

To the contrary, the statements issued by CFTC Commissioners Brian Quintenz and Dan Berkovitz in connection with ErisX's unsuccessful submission portend more administrative and legal developments with respect to event contracts. ErisX may file an amended submission, or another designated contract market ("DCM") may seek to list a contract that some, including the CFTC's staff, could claim to be "gaming" or another form of event contract.

Sportsbooks accepting wagers on sporting events have proliferated in the wake of the Supreme Court's 2018 decision invalidating a federal law that strictly limited sports betting.

In that likely event, the CFTC will need to grapple with myriad questions arising from the Commodity Exchange Act ("CEA") provision governing event contracts, a CFTC regulation implementing that provision, and derivatives market structure issues more broadly.

Listing new products

Under CFTC rules, a DCM can list new products by one of two methods. If it seeks to list the product promptly for trading, a DCM can certify one business day before it intends to list the product that the product complies with the CEA and CFTC regulations.[1] Alternatively, a DCM seeking more regulatory certainty can submit the product for Commission review and approval, which typically comes 45 days after submission.[2] The CFTC generally cannot block the listing of a product that a DCM self-certifies.

An exception exists, however, for "[a]n agreement, contract, transaction, or swap . . . that involves, relates to, or references terrorism, assassination, war, gaming, or an activity that is unlawful under any State or Federal law ['enumerated activities']" or that is similar to one of the enumerated activities and is determined by the Commission "to be contrary to the public interest."[3] If the Commission determines that a product submission under Rule 40.2 or 40.3 may fall within that exception, it can suspend the listing or trading of the product for 90 days while it conducts a review to determine whether to prohibit the product's trading.[4]

In adopting these rules, the CFTC cited its authority under a CEA provision added by the Dodd-Frank Wall Street Reform and Consumer Protection Act that prohibits the "clearing or trading" of futures or swaps that the Commission determines are "contrary to the public interest" and involve any of the enumerated activities or "similar activity."[5] That provision provided for this subset of contracts review authority that resembles far broader authority that the CFTC had at its creation to prevent the listing of *any* futures contract unless the DCM demonstrated that the contract "will not be contrary to the public interest."[6]

The legislative history of the original, much broader provision includes a discussion of the "public interest" standard, explaining that it would encompass whether the contract served an "economic purpose" — namely, whether the contract would provide producers, merchants, or consumers "a basis for determining prices" or provide "a means of hedging themselves against possible loss through fluctuations in price."[7] A contract that would be used "entirely or almost entirely for speculation" would not satisfy that standard.[8]

ErisX's submission

In December 2020, ErisX sought to self-certify its NFL contracts pursuant to Rule 40.2.[9] The contracts would permit taking positions on the moneyline (the winner of the game), the point spread between the winner and loser, and the total points scored by both teams.

The contracts are structured essentially as binary options with a winning position receiving a settlement price of $100 and the losing position receiving a settlement price of $0. The contracts would be financially settled (as many futures contracts are) and fully collateralized, obviating the need to exchange variation margin (unlike a typical futures contract).

ErisX's submission explained that sportsbooks accepting wagers on sporting events have proliferated in the wake of the Supreme Court's 2018 decision invalidating a federal law that strictly limited sports betting to a few locations.[10] This dramatic growth in sportsbooks has created a need for a hedging instrument for sportsbook operators, according to ErisX, because many of them hold "unbalanced book(s)" arising from in-state customers favoring their home team.[11]

The submission further asserted that stadium owners and vendors also have hedging needs because their revenue is largely dependent on attendance, which suffers when a team's performance lags. The NFL contracts thus could offset losses that sportsbooks and stadium owners and vendors would incur from imbalanced books and losing teams, respectively.

Commissioner Quintenz imagines the CFTC abstaining from a public interest review and thereby allowing by default a contract offering payouts based on terrorism or assassinations.

In line with these asserted hedging purposes, ErisX proposed to limit trading in the contracts to eligible contract participants ("ECPs") that either are "commercial market participants seeking to hedge their cash market exposure" or "designated market makers."[12] No retail customer trading would be allowed.

Determining that the NFL contracts "may involve, relate to, or reference . . . gaming," the CFTC invoked its authority under Rule 40.11(c) to conduct a 90-day review (through March 22, 2021), during which it would consider comments addressing whether the contracts should be permitted to trade. The Commission received 25 comment letters, most of which supported listing the NFL contracts. A day before the review period would have expired, however, ErisX withdrew its submission.

Commissioner Quintenz's statement

The timing of that decision would suggest that ErisX did so to avoid an anticipated adverse decision by the CFTC, and Commissioner Brian Quintenz issued a public statement that lends credence to that theory.[13]

Commissioner Quintenz disclosed the content of a proposed order drafted by CFTC staff that, according to the commissioner, would have classified the NFL contracts as involving "gaming" and, as such, prohibited by Rule 40.11.[14] Commissioner Quintenz further disclosed that the proposed order also would have found the contracts contrary to the public interest. In particular, the proposed order would have applied the public interest test that governed the Commission's review of all futures contracts before the CFMA and found that ErisX did not establish that its submitted contracts served either a hedging or price-basing function. The proposed order also would have found that the contracts could promote sports gambling, another factor cited to support a determination that they were contrary to the public interest.[15]

Commissioner Quintenz indicated he would have dissented from the proposed order, articulating several "sever[e] . . . concerns."[16] His concerns began with the CEA itself. In the commissioner's view, the CEA's event contract provision, section 5c(c)(5)(C), effects an unconstitutional delegation of legislative power to the CFTC. In particular, by providing that the Commission "may determine" that a contract is "contrary to the public interest" if it involves an enumerated or similar activity, (1) "it gives the Commission complete discretion on whether to . . . undertak[e] (or abstain[] from) a public interest determination" and (2) "that public interest determination is not bounded by any set of guiding principles or limiting circumstances."[17]

While Commissioner Quintenz is right to point out the breadth of the CFTC's discretion, the Supreme Court has not invalidated a statute on unconstitutional delegation grounds in nearly a century. To be sure, some justices have recently voiced an interest in reviving the nondelegation doctrine.[18]

The fact that the statute does not compel the CFTC to undertake a public interest analysis, however, may not be fatal. Commissioner Quintenz imagines the CFTC abstaining from a public interest review and thereby allowing by default a contract offering payouts based on terrorism or assassinations.[19] The CFTC might respond that it would not abdicate its overarching responsibility to oversee the derivatives markets to ensure they serve the congressionally specified "national public interest" in facilitating the management of price risk and the discovery and dissemination of pricing information.[20]

As for Commissioner Quintenz's concern that the "public interest" standard itself is "too vague . . . to be left to free-wheeling administrators,"[21] the CFTC would likely counter that, as noted above, Congress declared a "national public interest" in "providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."[22]

In the same provision, Congress also specifically identified other public purposes the CEA is designed to serve, including preventing manipulation, fraud and other market abuses, protecting the financial integrity of all transactions and avoiding systemic risk.[23] Given that express language, the CFTC would likely argue that Congress in other parts of the CEA gave sufficient content to the "public interest" standard to provide the CFTC an "intelligible principle" to apply.[24]

Commissioner Quintenz also argued that the regulation implementing section 5c(c)(5)(C) is invalid as contrary to that provision. Rule 40.11(a)(1) contains a *per se* prohibition on contracts involving an activity enumerated in the statute, namely, terrorism, assassination, war, gaming, or an activity that is unlawful under any federal or state law.

As the commissioner pointed out, however, the statute (that Rule 40.11(a)(1) purports to implement) conditions its prohibition of

such a contract on a determination by the CFTC that the contract is contrary to the public interest. In adopting the regulation, the CFTC did not make any determination that contracts involving the enumerated activities are categorically contrary to the public interest, much less justify such a categorical determination.

While the explanation for a categorical prohibition might seem self-evident for some of the enumerated activities, that would not appear to be the case for "gaming." After all, the CEA contemplates futures contracts based on "an occurrence, extent of an occurrence, or contingency . . . that is . . . beyond the control of the parties to the relevant contract, agreement or transaction" and is "associated with a financial, commercial, or economic consequence."[25] And market participants today can trade binary options involving predictions about GDP, the unemployment rate, weekly jobless claims and more.[26]

In Commissioner Berkovitz's view, if the NFL contracts would perform the hedging function that ERIS claimed of them, they would satisfy the public interest standard.

Moreover, some activities widely considered to be "gaming" are lawful today, unlike terrorism or assassination.[27] The Commission recognized the problem, noting in the preamble to the rule that what constitutes "gaming" needed "further clarification."[28] The Commission declined to offer it, however, stating instead that the definition of "gaming" might be the subject of a future rulemaking and that, in the meantime, questions about the scope of gaming activity would be addressed on a case-by-case basis.[29] Rule 40.11(a)'s *per se* prohibition of contracts involving "gaming" puts special pressure on the definition, since a determination that a contract involves gaming triggers the prohibition regardless whether the contract offers a hedging or price basing function.

Commissioner Quintenz also took issue with what he perceived as the proposed order's placing of the burden on ErisX to establish that its NFL contracts served a hedging function. The commissioner noted that while the CEA had initially required DCMs to demonstrate to the CFTC that their futures contracts were not contrary to the public interest, the CFMA removed that requirement in favor of permitting exchanges to self-certify their contracts.

As noted above, the Commission's ability to block the listing of self-certified products is narrowly circumscribed. Commissioner Quintenz argued that the Dodd-Frank event contract provision left the CFMA structure intact, thereby placing the burden on the Commission to demonstrate that the NFL contracts were contrary to the public interest. The question of where the burden of proof lies is a significant one and yet another issue the CFTC will need to resolve as prediction markets expand and more event contracts are self-certified.

Commissioner Berkovitz's statement

Commissioner Berkovitz also issued a statement on ErisX's submission but, unlike Commissioner Quintenz, he would have supported blocking the NFL contracts' listing.[30]

Commissioner Berkovitz concluded that the NFL contracts involved "gaming" within the meaning of CEA section 5c(c)(5)(C), observing that they have the same labels (moneyline, point spread, and over/under) as classic sports bets and are "structured to match the basic types of sports bets described by the [American Gaming Association]."[31] Commissioner Berkovitz agreed with Commissioner Quintenz, however, that the CEA event contracts provision "does not *require* the Commission to prohibit contracts involving gaming" but rather "provides the Commission with the *discretion* to prohibit them."[32]

In Commissioner Berkovitz's view, if the NFL contracts would perform the hedging function that ERIS claimed of them, they would satisfy the public interest standard.[33] But he found that "ErisX did not provide sufficient evidence that the NFL [c]ontracts would provide an effective and more-than-occasionally used hedging mechanism."[34]

ErisX's decision to limit trading in the NFL contracts to ECPs proved – paradoxically – to be another basis Commissioner Berkovitz identified for opposing them. While restricting trading to ECPs would seem (at least in a paternalistic way) to protect retail investors, a key Commission objective, Commissioner Berkovitz viewed the restriction as a violation of two DCM core principles.

Core Principle 2 addresses access requirements,[35] and the Commission by regulation has required DCMs to afford "impartial access to its markets and services."[36] Noting that he was not aware of a DCM ever having prevented retail customers from trading a particular contract, Commissioner Berkovitz concluded that it was "blatantly discriminatory to bar retail customers[,]" especially where that access restriction did not "relate to the permissible factors of [the DCM's] financial or operational soundness."[37]

Largely for the same reasons, Commissioner Berkovitz found the retail customer exclusion to violate Core Principle 19, which prohibits a DCM from (a) adopting any rule or taking any action "that results in any unreasonable restraint of trade" or (b) imposing "any material anticompetitive burden on trading on the contract market" unless the rule or action is "necessary or appropriate to achieve the purposes of [the CEA]."[38]

The commissioner reasoned that barring retail customers (and non-market making ECPs) from trading the NFL contracts "would be anticompetitive" because it would shield bookmakers from competition and ensure that retail customers could only "obtain their sports betting contracts from bookmakers."[39] This restriction on competition would mean less transparent and inferior prices for retail customers, who would be relegated "to the opaque price-setting process of a bookmaker or casino."[40] According to Commissioner Berkovitz, had retail customers been permitted to trade, they "would benefit from exchange-based prices that would more accurately reflect the market's assessment of the probability

of an event, rather than the odds dictated to the customer by a bookmaker."[41]

The competitive impact of the NFL contracts' prohibition on retail customers is beyond the scope of this article, but Commissioner Berkovitz's objections raise interesting market structure questions. In particular, under the CEA, retail customers are barred from trading swaps unless the swap is traded on a DCM.[42] Thus, swap execution facilities (SEFs) not only can, but *must* offer their swap contracts to ECPs only. It follows that the core principles applicable to SEFs — including nearly identical principles requiring SEFs "to provide market participants with impartial access" (SEF Core Principle 2)[43] and barring them from adopting unreasonable restraints of trade or imposing material anticompetitive burdens (SEF Core Principle 11)[44] — cannot be construed as prohibiting the listing of a swap that is limited to ECPs.

Given that the NFL contracts' retail customer exclusion could not be a basis for finding a violation of SEF core principles, and in light of the largely interchangeable nature of futures and swaps, a company seeking to list contracts like those ErisX proposed could encounter less resistance by labeling the contracts as swaps and offering them on a SEF.[45] Of course, the very fact that the SEF core principles cannot be read to prohibit swaps excluding retail customers raises questions about the wisdom of construing the DCM core principles to impose such a prohibition, notwithstanding the legitimate concerns Commissioner Berkovitz raises about the unlevel playing field for retail customers.

Conversely, Commissioner Berkovitz's concerns about the harm to competition and consumers arising from the NFL contracts' retail customer exclusion raises questions about the wisdom of the statutory prohibition on retail investors trading on SEFs, which are designed to bring the type of transparency to swaps trading that has long prevailed in centralized futures markets.

ErisX's withdrawal of its NFL contracts submission surely is not the final chapter on the CFTC's treatment of event contracts and contracts that potentially involve gaming in particular. As the statements by Commissioners Quintenz and Berkovitz illustrate, event contracts trigger a host of perplexing questions about the CEA, Commission regulations implementing the CEA, derivatives market structure, and the scope of an agency's authority to determine what lies in the public interest. As prediction markets continue to grow, market participants can be expected to work with and challenge the CFTC to continue to flesh out the appropriate criteria for evaluating whether a contract that may involve gaming falls on the permissible side of the line.

Notes

[1] *See* 17 CFR § 40.2.

[2] *See* 17 CFR § 40.3.

[3] 17 CFR § 40.11(a).

[4] *Id.* § 40.11(c).

[5] 7 U.S.C. § 5c(c)(5)(C).

[6] 7 U.S.C. § 7(g) (1982). Congress removed the CFTC's broad authority to review and block the listing of a futures contract in the Commodity Futures Modernization Act of 2000 ("CFMA"), giving DCMs the ability to self-certify that contracts comply with the CEA.

[7] H.R. Rep. No. 1383, 93rd Cong., 2d Sess. 36 (1974).

[8] H.R. Rep. No. 975, 93rd Cong., 2d Sess. 29 (1974).

[9] *See* ErisX, CFTC Regulation 40.2(a) Certification (Dec. 14, 2000), *available at* https://bit.ly/3BznRg2 ("Certification").

[10] *See Murphy v. National Collegiate Athletic Ass'n*, 138 S. Ct. 1461 (2018).

[11] Certification at 2.

[12] *Id.* at 4. The CEA defines an ECP to include, among others, financial institutions, insurance companies, investment companies, certain commodity pools, corporations with assets exceeding $10 million, and individuals whose discretionary investments exceed $10 million or exceed $5 million where the contract is entered to manage risk. *See* 7 U.S.C. § 1a(18).

[13] *See* Statement of Commissioner Brian D. Quintenz on ErisX RSBIX NFL Contracts and Certain Event Contracts, *available at* https://bit.ly/3DBZErm ("Quintenz Statement").

[14] *Id.* at 5.

[15] *Id.*

[16] *Id.* at 2.

[17] *Id.* at 6.

[18] *See Gundy v. United States*, 139 S. Ct. 2116, 2144-45 (2019) (Gorsuch, J. joined by Roberts, C.J., and Thomas, J., dissenting); *Id.* at 2131 (Alito, J., concurring in the judgment); *see also Paul v. United States*, 140 S. Ct. 342 (2019) (Kavanaugh, J. dissenting from denial of certiorari).

[19] Quintenz Statement at 6.

[20] *See* 7 U.S.C. § 5(a).

[21] Quintenz Statement at 7.

[22] 7 U.S.C. § 5(a).

[23] *Id.* § 5(b).

[24] The legislative history of the "public interest" test that the CFTC applied for a quarter century (before the CFMA) in reviewing all futures contracts made the tie between the "public interest" test and the statutory purpose provision explicit. *See* nn. 7-8, *supra*.

[25] 7 U.S.C. § 1a(19)(iv).

[26] *See* https://bit.ly/2WNbMol; *See* also https://bit.ly/3gTorgJ ("Kalshi, the first federally regulated exchange dedicated to trading directly on the outcome of events, is now in public Beta.").

[27] *See* Statement of Commissioner Dan M. Berkovitz Related to Review of ErisX Certification of NFL Futures Contracts, *available at* https://bit.ly/3DGAZlm ("Berkovitz Statement") at 3, 8 n.31 (discussing state laws authorizing sports betting).

[28] Provision Common to Registered Entities, 76 Fed. Reg. 44776, 44785 (July 27, 2011).

[29] *Id.*

[30] *See generally* Berkovitz Statement.

[31] *Id.* at 3.

[32] *Id.*

[33] Without addressing Commissioner Quintenz directly, Commissioner Berkovitz appeared to address his concern that the public interest standard is unbounded, observing that the Commission "should be wary" of going beyond an evaluation of economic purpose and "second-guess[ing]" the judgments of state and federal legislatures where they have chosen to permit the underlying activity. *Id.* at 4 n.33. This observation suggests Commissioner Berkovitz would not have found, as the proposed order apparently did, that the NFL contracts' promotion of gambling was contrary to the public interest; instead Commissioner Berkovitz acknowledged the "sports betting landscape today," where "[h]alf of the states and the District of Columbia have legalized sports betting, and more are considering whether to do so." *Id.* at 3. This landscape contrasts with the landscape that formed the backdrop for Nadex's proposal to list binary option contracts on the outcome of specified federal elections. The CFTC issued an order barring the trading of these political event contracts, concluding that they served neither a hedging nor price-basing function and also posed a threat to the integrity of elections. *See* In the Matter of the 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, Order Prohibiting the Listing or Trading of Political Event Contracts, *available at* https://bit.ly/3gPPmu8.

[34] *Id.* at 4.

[35] *See* 7 U.S.C. § 7(d)(2).

[36] 17 C.F.R. § 38.151(b).

[37] Berkovitz Statement at 5.

[38] 7 U.S.C. § 7(d)(19).

[39] Berkovitz Statement at 5.

[40] *Id.*

[41] *Id.*

[42] *See* 7 U.S.C. § 2(e).

[43] 7 U.S.C. § 7b-3(f)(2)(B)(i).

[44] *Id.* § 7b-3(f)(11).

[45] As noted above, while Eris X labeled its contracts as futures, they resemble binary options, which, post-Dodd-Frank, are swaps.

About the author

Jonathan Marcus is a partner in **Reed Smith**'s Energy & Natural Resources Practice Group in the firm's Washington, D.C., office. He represents clients in litigation related to derivatives, securities and energy markets. He also advises companies on commodity, derivatives and digital asset regulation and on government enforcement matters before the Commodity Futures Trading Commission, the Securities and Exchange Commission and the Federal Energy Regulatory Commission. He is also the former general counsel of the CFTC. He can be reached at Jonathan.Marcus@reedsmith.com.

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