
CFTC, Fifth Circuit Upend the Future of Prediction Markets¹

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The Commodity Futures Trading Commission (CFTC) recently issued an order disapproving the listing of a political event contract self-certified by a designated contract market (DCM). This was a long-awaited decision in an ongoing debate within and outside the CFTC regarding the future of federally regulated political event contracts. These issues are not new; they have been present and before the CFTC for more than a decade. However, this recent CFTC disapproval comes just after the Fifth Circuit Court of Appeals issued a related and important opinion regarding the operation of a political event contract market pursuant to long-standing CFTC no-action relief.

Taking all this together, the future appears grim for CFTC-regulated political event contracts. While CFTC staff have permitted these markets to exist in a semi-regulated environment for a decade pursuant to a no-action letter relief,² these recent actions suggest that the CFTC will continue to take steps to limit—or eliminate—the existence of CFTC-regulated political event contracts as derivatives, even if the Fifth Circuit's recent decision delays the CFTC's goals temporarily.

This alert summarizes these two recent developments and their potential implications for future event contract markets, as well as the scope of the CFTC's anti-fraud and anti-manipulation authority (which comes up frequently in the digital asset spot market context). We also analyze the potential impact on the CFTC's practices with respect to staff no-action letters after the Fifth Circuit decision.

Kalshi Disapproval of Congressional Control of Political Event Contracts

On Friday, September 22, 2023, the CFTC issued an order disapproving a certification by KalshiEX LLC pursuant to CFTC Regulation 40.2 (the Order).³ The original submission, filed June 12, 2023,

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² CFTC Letter No. 14-130 (Oct. 29, 2014), available at <https://www.cftc.gov/csl/14-130/download>.

³ In the Matter of the Certification by KalshiEX LLC of Derivatives Contracts with Respect to Political Control of the United States Senate and United States House of Representatives, available at <https://www.cftc.gov/sites/default/files/filings/documents/2023/orgkexkalshiorsig230922.pdf>.

related to a contract that allowed participants to take positions on which political party would control the US House of Representatives and which would control the US Senate (Congressional Control Contracts).

Specifically, the Kalshi contract was a “cash-settled, binary (yes/no) contracts based on the question: ‘Will <chamber of Congress> be controlled by <party> for <term>?’” Upon settlement, the winning side of the contract would be paid, and no payment would be made to the counterparty that selected the minority political party.

On June 12, 2023, Kalshi certified that the listing complied with the Commodity Exchange Act (CEA) and CFTC regulations. However, a self-certification pursuant to CFTC Regulation 40.2 does not entail or amount to CFTC approval of that product. On June 23, 2023, the CFTC commenced a review of the Congressional Control Contracts, which included a public comment period that yielded 1,378 comments. In announcing the review and public comment period, the CFTC indicated that the Congressional Control Contracts may involve, relate to or reference an activity enumerated in CFTC Regulation 40.11 and CEA section 5c(c).

CFTC Regulation 40.11 provides that DCMs “shall not list for trading or accept for clearing” any contract based on an excluded commodity, as defined in CEA section 1a(19)(iv), that “involves, relates to, or references terrorism, assassination, war, gaming, or an activity that is unlawful under any State or Federal law.” CFTC Regulation 40.11 also prohibits contracts that the CFTC determines “to be contrary to the public interest.”

In disapproving the contracts, the CFTC concluded that:

1. the Congressional Control Contracts involve gaming and activity that is unlawful under State law; and
2. the Congressional Control Contracts are contrary to the public interest.

In the Order, the CFTC explains:

1. The Congressional Control Contracts “involved” gaming, which is a prohibited category of commodity under CEA Section 1a(19) because “taking a position in the Congressional Control Contracts would be staking something of value upon the outcome of a contest of others.”

The Order includes a lengthy analysis about the use of the word “involve,” as opposed to “based on” or “based upon.” The CFTC notes that “involve” means “to relate to or affect” or “to relate closely” in connection with an enumerated activity (in this case, gaming), while “based on” refers to an underlying reference entity (such as an agricultural commodity). In a footnote, the CFTC also analyzes the word “involve,” citing a 2010 Senate floor colloquy between Senator Dianne Feinstein and Senator Blanche Lincoln, then-chair of the Senate Agriculture Committee. Senator Lincoln stated that the provision ultimately enacted as CEA section 5c(c)(5)(C) “was intended to ‘prevent gambling through futures markets’ and

to restrict exchanges from ‘construct[ing] an ‘event contract’ around sporting events such as the Super Bowl, the Kentucky Derby, and Masters Golf Tournament.’”⁴

2. The Congressional Control Contracts would involve “activity that is unlawful under . . . State law,” pursuant to CEA section 5c(c)(5)(C)(i) and CFTC Regulation 40.11(a)(1) because taking a position in the Congressional Control Contracts would be staking something of value upon the outcome of contests between electoral candidates, and in many states such conduct is illegal.⁵

The CFTC notes that “a common thread throughout the large majority of definitions of ‘gaming’ and ‘gambling’ is the act of staking something of value on the outcome of a contest of others.”⁶ The CFTC explains that the Congressional Control Contracts involve “wagering” on election outcomes, which is unlawful activity in a number of states.⁷ The CFTC dismisses Kalshi’s argument that CFTC approval would preempt certain state laws by concluding that permitting this activity on a DCM “would undermine important state interests expressed in statutes separate and apart from those applicable to trading on a DCM.”⁸ The Order also sets forth why an election is a “contest” and that “it is common parlance to refer to elections as contests,” citing an article in the *Washington Post* and state gaming statutes.⁹

3. The Congressional Control Contracts could not reasonably be expected to be used for hedging and/or price basing on more than an occasional basis, and the Congressional Control Contracts could not reasonably be expected to be used predominantly by market participants having a commercial or hedging interest.¹⁰

The CFTC distinguishes between traditional futures contracts that “have not been premised on the outcome of a contest of others” but rather “have served hedging and risk management functions, and have therefore been designed to correlate to direct and quantifiable changes in the price of commodities or other financial assets or instruments.”¹¹

The CFTC further explains that other event contracts, such as Kalshi’s Heating and Cooling Degree Day futures contracts and real estate index contracts, “generally have more specific and targeted hedging utility than the Congressional Control Contracts.” The CFTC also identifies material differences between those contracts, such as settlement calculation information.¹²

⁴ *Id.* n. 17.

⁵ *Id.* at 12.

⁶ *Id.* n. 25.

⁷ *Id.* at 11.

⁸ *Id.* n. 28.

⁹ *Id.* n. 25.

¹⁰ *Id.* at 19.

¹¹ *Id.* at 18.

¹² *Id.* n. 35.

4. The Congressional Control Contracts are not in the public interest and could potentially be used in ways that would have an adverse effect on the integrity of elections or the perception of integrity of elections—for example, by creating monetary incentives to vote for particular candidates, even when such votes may be contrary to a voter’s (or an organized group of voters’) political preferences or views of such candidate.¹³
5. Unlike with other “underlying” markets, such as traditional agricultural or energy markets, in its role as the regulator of the Congressional Control Contracts, the CFTC would be required to investigate suspected manipulation in election-related activities—potentially including the outcome of an election itself, which is not a role for which the CFTC is equipped.¹⁴

In rejecting the Congressional Control Contracts, CFTC Chairman Rostin Behnam noted his concern in extending the CFTC’s authority beyond its mandate. Behnam explained his position, saying that although the CFTC has the authority to combat fraud and manipulation, it would be impractical to use such authority for political events. Specifically, he believes, “The implications of such authority are vast, and could extend in a multitude of directions beyond the election itself, [such as to] political fundraising and polling, to name just two.”¹⁵

Two CFTC commissioners dissented, for very different reasons. Commissioner Summer Mersinger dissented from the CFTC’s decision to reject the Congressional Control Contracts because of her dissatisfaction with the CFTC’s approach to determining whether to approve or deny the Congressional Control Contracts.¹⁶ Commissioner Caroline Pham abstained from voting on the Order, citing the CFTC’s ongoing Fifth Circuit litigation with PredictIt (discussed below). Pham’s concerns stem from the potential for her vote to be construed as violating the injunction that enjoins the CFTC from “prohibiting or deterring the trading” of contracts listed on PredictIt, which include political event contracts.¹⁷

Fifth Circuit Finds That CFTC Staff Action Is Final Agency Action

The CFTC’s Kalshi disapproval order distinguishes the Congressional Control Contracts from two markets that operate pursuant to Division of Market Oversight no-action positions “on a small-scale, not-for-profit basis for academic purposes.” These two markets operate with “limitations on, among

¹³ *Id.* at 20.

¹⁴ *Id.* at 22.

¹⁵ Statement of Chairman Rostin Behnam Regarding CFTC Order to Prohibit Kalshi Political Control Derivatives Contracts (Sept. 22, 2023), available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement092223>.

¹⁶ Dissenting Statement of Commissioner Summer K. Mersinger Regarding Order on Certified Derivatives Contracts with Respect to Political Control of the U.S. Senate and House of Representatives (Sept. 22, 2023), available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/mersingerstatement092223>.

¹⁷ Statement of Commissioner Caroline D. Pham Regarding Political Event Contracts (Sept. 22, 2023), available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/phamstatement092223>.

other things, the number of market participants and the number of contracts that each market participant may hold.”

One of these markets, PredictIt, recently obtained an injunction from the Fifth Circuit Court of Appeals¹⁸ in response to the CFTC’s Division of Market Oversight’s (DMO) August 2022 attempt to withdraw the 2014 no-action letter issued to Victoria University of Wellington in Wellington, New Zealand, that permitted it to operate a political and economic indicator event contract market without registration as a DCM.

The Fifth Circuit is the first court “to draw the conclusion that a ‘no-action letter’ constitutes ‘final agency action.’” Judge James. E. Graves’ dissent notes that he has not “come across any instance where a court has ruled that a ‘no-action letter’ constitutes a final action taken by the agency.”¹⁹

In a split 2-1 vote, the panel found that a no-action letter is agency action under the Administrative Procedure Act (APA), citing to prior cases where “grants of permission to avoid compliance with administrative requirements constitute agency action.”²⁰ Further, the Court of Appeals found that the no-action letter at issue here is a “license” within the meaning of the APA.²¹ Thus, the court found that withdrawal of the no-action letter constituted agency action.

In determining whether the withdrawal of the letter is considered “final,” the Fifth Circuit denoted two determining factors: (1) the action must mark the consummation of the agency’s decision-making process; and (2) the action must be one by which rights or obligations have been determined, or which result in legal consequences.²² The panel found that both prongs of the “finality” test are met.

The first condition is that the DMO decision to issue or withdraw the no-action letter cannot be appealed within the agency, and also that CFTC regulations state that a beneficiary “may rely” on DMO issuing a no-action letter.²³ Second, the panel cited its previous 2019 decision in *Data Marketing Partnership v. U.S. Department of Labor*, in which the Fifth Circuit determined “where agency action withdraws an entity’s previously held discretion, that action alters the legal regime, binds the entity, and thus qualifies as final agency action.”²⁴ Further, the Fifth Circuit found that the relevant regulation stated that requesters may “rely” on an advisory opinion, thereby binding the Department of Labor and withdrawing its previously held discretion.²⁵ Thus, the panel found that

¹⁸ *Clarke et al v. CFTC*, No. 22-51124 (5th Cir. 2023).

¹⁹ *Id.* at 25.

²⁰ *Id.* at 8-9. Citing *Atl. Richfield Co. v. United States*, 774 F.2d 1193, 1200 (D.C. Cir. 1985) (discussing one such “temporary license”); *Gallagher & Ascher Co. v. Simon*, 687 F.2d 1067, 1072–76 (7th Cir. 1982) (reviewing withdrawal of a special permit exempting customs brokers from ordinary requirements).

²¹ *Id.* at 9.

²² *Id.* at 9. Citing *Data Mktg. P’ship v. U.S. Dep’t of Lab.*, 45 F.4th 846, 853 (5th Cir. 2022); *Bennett v. Spear*, 520 U.S. 154, 177–78 (1997).

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

Victoria's no-action letter withdrew some of the CFTC's discretion because a beneficiary may rely on it, and legal consequences resulted from the no-action letter.²⁶

Second, on the question of agency discretion not subject to judicial review, the Fifth Circuit disagreed with the CFTC's argument that no-action letters are like agency discretion to not prosecute or enforce and thus are unreviewable. The panel determined that the withdrawal of a "regulatory instrument" (the no-action letter) is what is being challenged here, not the CFTC's discretion to not enforce the law.²⁷

Lastly, the Fifth Circuit addressed the issue of whether the plaintiffs have standing considering Victoria University is not included in the lawsuit. The panel found that the standing requirements are easily satisfied in this case, saying that "market operators, traders, and academics claiming to be impacted by the no-action letter's rescission" have shown numerous injuries that are traceable to the withdrawal of the no-action letter.²⁸ The panel therefore concluded that the District Court for the Western District of Texas erred in not issuing a preliminary injunction and remanded the case to enter the injunction and hear the merits of claims in this case.

The Fifth Circuit PredictIt decision will result in the CFTC (and other regulatory agencies) likely reviewing requests for no-action relief more carefully and taking greater steps to clarify that a staff no-action letter does not constitute final agency action.

What the Kalshi and PredictIt Actions Mean for the Future of Event Contract Markets

Many of the CFTC's concerns in the Kalshi determination remain the same as those that were raised when the North American Derivatives Exchange (Nadex) attempted to list political control contracts in 2011, which the CFTC denied in 2012. The CFTC has consistently focused on the issue of election prediction markets as a form of gaming. Those fears may be heightened given the preexisting concerns surrounding US election integrity that have grown over the past election cycle.

The Kalshi denial order and the CFTC's pursuit to revoke the PredictIt no-action letter suggest the CFTC may continue to take steps to dissociate itself from political event contract markets. The CFTC may, in the future, engage in a notice-and-comment rulemaking on the issue, as Mersinger suggests. Until then, however, the impact of these two events is to raise the barriers to entry in the event contract marketplace and, at the same time, make it more difficult to obtain staff no-action letter relief in all areas subject to CFTC regulation.

²⁶ *Id.* at 10-11.

²⁷ *Id.* at 12.

²⁸ *Id.* at 13.

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