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## The Case for Domestic Box Office Receipt Derivatives

*Jeremy A. Gogel\**

### INTRODUCTION

Derivatives have been given a bad rap over the last two years. Following the sub-prime mortgage crisis and the ensuing economic collapse of 2008, many commentators and political figures targeted derivatives as one of the main causes of the financial crisis.<sup>1</sup> Derivatives were immediately branded as “risky,” “complex,” and “impossible to understand,” and were even analogized to gambling.<sup>2</sup> Indeed, derivatives are risky instruments if used carelessly, but if used properly, they provide a useful hedging device. These instruments have been traded on-exchange and over-the-counter in the United States for nearly as long as the country has existed, and have traded in other countries for millennia.<sup>3</sup>

While the basic principles of these contracts have largely remained the same over time, the types of underlying assets, indices, or rates from which derivatives derive their value have expanded. Derivatives were originally used by farmers, processors, and end users of agricultural products to hedge against the risk of abrupt swings in the price of crops, but eventually began to be used to hedge against interest rate swings, credit risk, currency prices, weather changes, and even

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<sup>1</sup> See Dorit Samuel, *The Subprime Mortgage Crisis: Will New Regulations Help Avoid Future Financial Debacles?*, 2 ALB. GOV’T L. REV. 217, 220 (2009).

<sup>2</sup> See, e.g., *id.* at 232–37.

<sup>3</sup> *Id.* at 233.

death.<sup>4</sup> Despite their wide ranging use, Congress, in response to the 2008 financial crisis, sought to strengthen the existing derivative regulations, and in doing so banned trading of derivatives tied to box office receipt numbers.<sup>5</sup>

At the time Congress passed this legislation, there had never been any exchange trading of box office derivatives, and little to no over-the-counter trading of box office derivatives.<sup>6</sup> Despite the lack of contribution by these instruments to the financial crisis, Congress nonetheless took the request by two recently created box office derivatives exchanges to begin listing and trading contracts as further evidence of the excesses and reckless behavior of the financial sector.<sup>7</sup> By banning box office derivatives, Congress halted an opportunity to bring additional financing to the movie industry and potentially stifled future creativity in the derivative markets.<sup>8</sup> Additionally, the ban on box office receipt derivatives marks the first time in nearly thirty years that Congress has prohibited trading of a derivative instrument for a specific underlying asset, and only the third time in U.S. history that it banned trading of derivatives for a specific commodity.<sup>9</sup> After passage of the new regulations, the only two commodities on which derivatives cannot be traded in the United States are onions and box office receipts.<sup>10</sup>

This Article will discuss the origin and regulation of derivatives, the purpose behind the creation of box office derivative exchanges, and why Congress banned the trading of box office derivatives. The Article will conclude with a discussion of why Congress' decision to ban box office derivatives has the potential to hurt the movie industry, as well as future financial innovation in general.

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<sup>4</sup> Don M. Chance, *A Brief History of Derivatives*, in *ESSAYS IN DERIVATIVES* 16, 17–19 (1998).

<sup>5</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 721(a)(4), 124 Stat. 1376, 1659 (2010).

<sup>6</sup> See Todd Shields & Michael White, *Box-Office Futures Market Wins U.S. Approval*, BLOOMBERG (Apr. 21, 2010), <http://www.bloomberg.com/news/2010-04-20/cantor-wins-cftc-s-approval-for-movie-futures-market-opposed-by-hollywood.html>.

<sup>7</sup> Letter from Tom Ashton, CEO, Vantage Advisor Group, LLC, to Andrew Wing, Pres. & CEO, Cantor Entertainment (Apr. 26, 2010), *available at* <http://www.cantorexchange.com/getdoc/6bc630b2-33e0-4eb0-9ee2-4e20c1d5bc79/Vantage-Advisors-Letter-on-Box-Office-Futures.aspx>.

<sup>8</sup> Letter from Michael Burns, CEO, Lionsgate, to H.R. Comm. on Agriculture (Apr. 16, 2010), *available at* <http://www.cantorexchange.com/getdoc/bb0c85fe-0cf1-434c-8444-b3e2c02866ea/Lionsgate-Burns-Letter-to-House-Committee-on-Agric.aspx>.

<sup>9</sup> See Alan Greenspan, Chairman, U.S. Fed. Reserve, Address at the Financial Markets Conference of the Federal Reserve Bank of Atlanta, Georgia: Government Regulation and Derivative Contracts (Feb. 21, 1997) [hereinafter Greenspan, Government Regulation and Derivative Contracts], *available at* <http://www.federalreserve.gov/BoardDocs/Speeches/1997/19970221.htm>.

<sup>10</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, § 721(a)(4).

## I. INTRODUCTION TO DERIVATIVES

## A. What are Derivatives?

A derivative is a “financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity.”<sup>11</sup> There is no singular type of derivative instrument, but rather, a family of instruments who derive their values from reference points.<sup>12</sup> These reference points can be currency exchange rates, interest rates set by financial institutions, prices of securities such as stocks or bonds, prices of physical commodities such as precious metals or harvested farm products, weather patterns,<sup>13</sup> and even mortality dates.<sup>14</sup>

The most common derivative instruments are forward and futures contracts, swaps, and options, with each having distinct payment and/or delivery terms.<sup>15</sup> Futures and options are used for hedging (i.e., shifting the risk of price changes to those who are more willing or able to assume this risk), or for speculation (i.e., investing with the intent of profiting from price changes).<sup>16</sup> Swaps and forwards are “typically used to hedge or to obtain more desirable financing.”<sup>17</sup> Swaps can be used to speculate, but are generally not used as frequently for this purpose because of the relatively high transaction costs compared to those of other derivatives.<sup>18</sup> Thus, only participants willing to operate on a

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<sup>11</sup> BLACK’S LAW DICTIONARY 374 (9th ed. 2005).

<sup>12</sup> See Samuel, *supra* note 1, at 233.

<sup>13</sup> Various weather derivative products are traded on the Chicago Mercantile Exchange. These products typically derive their values from fluctuations in temperatures. For an overview, see J. SCOTT MATHEWS, CME GROUP, WEATHER PRODUCTS: DOG DAYS AND DEGREE DAYS (2009), available at [http://www.cmegroup.com/trading/weather/files/WT133\\_Weather\\_White\\_Paper\\_Final.pdf](http://www.cmegroup.com/trading/weather/files/WT133_Weather_White_Paper_Final.pdf); Bob Dischel, *Weather Risk Management at the Frozen Falls Fuel Company*, CME GROUP, [http://www.cmegroup.com/trading/weather/files/WEA\\_weather\\_risk.pdf](http://www.cmegroup.com/trading/weather/files/WEA_weather_risk.pdf) (last visited Nov. 3, 2010).

<sup>14</sup> Cris Sholto Heaton, *Have Financial Wizards Found a Way to Outwit Death?*, MONEYWEEK (Nov. 24, 2006), <http://www.moneyweek.com/investments/have-financial-wizards-found-a-way-to-outwit-death.aspx>.

<sup>15</sup> See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO/GGD-94-133, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEMS 26 (1994) [hereinafter GAO REPORT ON FINANCIAL DERIVATIVES], available at <http://archive.gao.gov/t2pbat3/151647.pdf>. More complex derivatives can be created by combining the elements of basic derivatives. For example, a swaption gives the holder the option, but not the obligation, to enter into a swap on or before a specified future date. An interest rate cap (or floor) agreement is a derivative in which the buyer receives payments at the end of each period in which the interest rate exceeds (or is below) the specified reference rate. See *id.* at 172.

<sup>16</sup> *Id.* at 25.

<sup>17</sup> *Id.* at 26.

<sup>18</sup> *Id.*

large scale have the potential to make swap speculation worthwhile.

Forward and futures contracts are similar, except that a forward contract is negotiated, settled, and cleared privately between two parties, while a futures contract is entered into on an exchange, settled, and cleared by a central clearing party (CCP).<sup>19</sup> An individual who buys a forward or futures contract assumes what is known as a “long” position.<sup>20</sup> The seller of a forward or futures contract assumes what is known as a “short” position.<sup>21</sup> The two parties, by taking these positions, assume the respective obligation to buy and sell the underlying asset at a specific price sometime in the future.<sup>22</sup> The holder of a long position benefits when the price of the underlying asset increases, while the holder of a short position benefits when the price of the underlying asset decreases.<sup>23</sup> A party to a futures contract has two choices on how to liquidate its position. The first option is to liquidate the position prior to the settlement date.<sup>24</sup> This option requires the party to take an offsetting position in the same contract.<sup>25</sup> For the buyer of a futures contract, “this means selling the same number of identical futures contracts; for the seller of a futures contract, this means buying the same number of identical futures contracts.”<sup>26</sup> Alternatively, a party can wait until the contract settlement date.<sup>27</sup> Then, “the party purchasing a futures contract accepts delivery” of the underlying asset, or settlement is made in cash.<sup>28</sup>

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<sup>19</sup> Clearance is the process of acquiring trade data, comparing buyer and seller versions of the data, and guaranteeing that the trade will settle once the data is matched. Settlement is the process of determining the daily closing price for each contract and collecting losses from clearing members carrying losing positions and making payments to clearing members carrying gaining positions. See EUGENE F. BRIGHAM & MICHAEL C. EHRHARDT, *FINANCIAL MANAGEMENT: THEORY AND PRACTICE* 827–28 (12th ed. 2008).

<sup>20</sup> *Frequently Asked Questions About Futures Trading*, GOWEBTRADE, <http://www.gowebtrade.com/ztrading-products/futures> (last visited Oct. 10, 2010).

<sup>21</sup> *Id.*

<sup>22</sup> BRIGHAM & EHRHARDT, *supra* note 19, at 827.

<sup>23</sup> For instance, imagine that Party A bought a futures contract from Party B, whereby Party A would purchase 100 barrels of crude oil from Party B for \$100 per barrel in one year. If, in one year, the price of crude oil is selling for \$125 per barrel, Party A would be the “winner” because he is saving \$25 per barrel. Party B, on the other hand, would be the “loser” because he is selling his oil at a \$25 per barrel discount. Of course, the opposite would be true if the price of oil were selling for \$75 per barrel in one year. See GARY SHOUP, *CURRENCY RISK MANAGEMENT: A HANDBOOK FOR FINANCIAL MANAGERS, BROKERS, AND THEIR CONSULTANTS* 75 (1998).

<sup>24</sup> PETER K NEVITT & FRANK J. FABOZZI, *PROJECT FINANCING* 230 (7th ed. 2000)

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

Because forward contracts are privately negotiated, it is up to the parties to determine how the positions can be liquidated.<sup>29</sup>

Option contracts give the purchaser the right to buy (call option) or sell (put option) a specified asset at a particular price (exercise price) on or before a certain future date.<sup>30</sup> In exchange for the right to buy or sell the particular asset, the purchaser pays the seller (writer) a certain amount (option premium).<sup>31</sup> Options are different from forwards and futures in that they do not create an obligation on the part of the purchaser to buy or sell the underlying asset.<sup>32</sup> Options that expire without being exercised do so with no value. Thus, a purchaser of an option would only lose his option premium if he decides not to exercise the option.<sup>33</sup> Options, like futures, may be exchange-traded, or, like forwards, may be privately negotiated.<sup>34</sup> Additionally, the buyer of an option assumes a long position, while the writer of an option assumes a short position.<sup>35</sup>

A swap transaction is similar to a forward or futures contract, except that it has a multiple period structure with corresponding multiple payments.<sup>36</sup> For instance, in a fixed-for-floating interest rate swap:

[O]ne party agrees to pay an amount equal to a stated fixed interest rate applied to a notional amount, and the other party agrees to pay an amount determined by reference to the value of a specified floating interest rate (e.g., LIBOR) for the applicable period as applied to the same notional amount.<sup>37</sup>

The number of periods for which the swap applies to is predetermined by the parties.<sup>38</sup> In addition to fixed-for-floating

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<sup>29</sup> *Id.*

<sup>30</sup> See GAO REPORT ON FINANCIAL DERIVATIVES, *supra* note 15, at 27.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> For instance, imagine that Party A owns one share of stock in XYZ, Corp. Party A decides to sell Party B the right to buy this share for \$45 within the next six months. The premium on this call option is \$5. As soon as the price of XYZ's stock exceeds \$50, Party A would exercise his option, and purchase the stock, because at that point, the sum of the exercise price and option premium is less than the price of the stock. Depending on the terms of the option contract, there may be a transfer of ownership of the stock from the option writer to the option buyer, or the option writer may merely pay the option purchaser the difference between the sum of the exercise price and option premium, and the market price of the stock at the time the option is exercised. If the price of XYZ's stock drops, however, Party A would simply let the option expire, and simply pay (if he had not done so already) Party B the option premium. *See id.*

<sup>34</sup> *Id.* at 26–27.

<sup>35</sup> See NEVITT & FABOZZI, *supra* note 24, at 245.

<sup>36</sup> Mark A. Guinn & William L. Harvey, *Taking OTC Derivative Contracts as Collateral*, 57 BUS. LAW. 1127, 1131 (2002).

<sup>37</sup> *Id.*

<sup>38</sup> For instance, imagine that Party A owns a bond with a \$1,000 par value paying a fixed interest rate of 5% compounded annually. If Party B owns a similar bond paying a

swaps, parties can enter into fixed-for-fixed swaps, floating-for-floating swaps, or any combination they desire.<sup>39</sup> Parties can also enter into swap transactions where the occurrence of a particular event (e.g., default on mortgage payments) would require clearance and settlement between the parties.<sup>40</sup> Other similar transactions include currency and commodity swaps. Historically, swaps have been entered into privately between the parties because of their unique nature; however, recent legislation has created a presumption that these types of contracts will be cleared through a CCP going forward.<sup>41</sup> Swaps enjoy higher transactions costs than exchange-traded derivatives due to their unique nature, which sometimes require extensive negotiations between the parties.<sup>42</sup>

### B. How Are Derivatives Regulated?

As noted above, derivatives fall into two main categories. One category consists of standardized, exchange-traded instruments, while the other category consists of customized, privately negotiated instruments known as over-the-counter (OTC) derivatives.<sup>43</sup> Although many derivative contracts have historically been exchange-traded, the number of OTC derivatives far outnumbers the size of the exchange-traded contracts market.<sup>44</sup> These contracts differ in the ways they are regulated.

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floating interest rate tied to the LIBOR, Party B may want to hedge against the risk of the interest rate plummeting, and simultaneously guarantee a known, steady stream of income. Party A, on the other hand, may want to trade the guaranteed interest payments for the possibility of larger interest payments. Thus, if the two parties enter into an interest rate swap transaction, when the interest is paid on the two bonds, any interest payments above \$50 would have to be paid from Party B to Party A. Conversely, if Party B received less than \$50 in interest at the end of the year, Party A would have to pay Party B the difference between what he was actually paid, and the \$50. Note that Party B will never receive more or less than \$50 in this transaction, but that Party A has the potential to earn more than \$50, as well as the potential to earn less than \$50. It should also be clear that ownership of the underlying instruments—in this case, the bonds—never switches hands. See Samuel, *supra* note 1, at 237.

<sup>39</sup> *Id.*

<sup>40</sup> Kathryn M. Trkla, *Implications of the Financial Reform Legislation for Derivatives Activities*, LEGAL NEWS ALERT, July 2010, at 2, available at <http://www.foley.com/abc.aspx?Publication=7351>.

<sup>41</sup> See *infra* Part I.B.1.ii.

<sup>42</sup> Patrick Casabona, *Derivatives*, in 1 ENCYCLOPEDIA OF BUSINESS AND FINANCE 235, 237 (Burton S. Kaliski ed., 2001).

<sup>43</sup> *Product Descriptions and Frequently Asked Questions*, INT'L SWAPS & DERIVATIVES ASS'N, INC., <http://www.isda.org/index.html> (last visited Oct. 10, 2010).

<sup>44</sup> *Regular OTC Derivatives Market Statistics*, BANK FOR INT'L SETTLEMENTS (Nov. 12, 2009), [http://www.bis.org/publ/otc\\_hy0911.htm](http://www.bis.org/publ/otc_hy0911.htm). The Bank of International Settlements estimates that the total notional amount of outstanding OTC contracts at the end of June 2009 was \$605 trillion. *Id.* This amount is contrasted with the GAO's estimate of the notional amount of *all* outstanding derivatives contracts (including exchange traded contracts) at the end of the 1992 fiscal year which was \$12.1 trillion. See

### 1. Exchange-Traded Derivatives Regulation

Exchange-traded derivatives are primarily regulated by two federal government agencies—the Commodity Futures Trading Commission (CFTC), and the Securities and Exchange Commission (SEC).<sup>45</sup>

#### i. CFTC Regulation

U.S. derivatives regulation began during the Civil War when Congress passed the Anti-Gold Futures Act.<sup>46</sup> The Act was passed in response to the significant discount at which the Union's "fiat currency"—known as the greenbacks—was trading in comparison to gold.<sup>47</sup> The Act made it unlawful to enter into any contract for the purchase of gold coin, gold bullion, or foreign exchange to be delivered on any day after the making of such a contract.<sup>48</sup> Unfortunately, instead of stabilizing the price of the greenbacks, Congress' attempt at regulating gold and foreign currency futures led to the further decline in the value of the greenbacks.<sup>49</sup> As a result, Congress repealed the Act only two weeks after it was enacted.<sup>50</sup>

Between the years of 1880 and 1920, Congress introduced approximately two hundred bills that would regulate futures exchanges, but none of this proposed legislation passed.<sup>51</sup> Congress' next attempt to regulate futures came in 1921 when it passed the Future Trading Act.<sup>52</sup> The Future Trading Act imposed a twenty cent tax per bushel on every grain futures contract, but exempted sales on boards of trade designated as contract markets by the Secretary of Agriculture from this

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GAO REPORT ON FINANCIAL DERIVATIVES, *supra* note 15, at 34. See also Committee Report on the Restoring American Financial Stability Act of 2010, S. REP. NO. 111-176, at 29 (2010), available at [http://banking.senate.gov/public/\\_files/S3217ReportASFILED.pdf](http://banking.senate.gov/public/_files/S3217ReportASFILED.pdf) ("By 2008, 59 percent of derivatives were traded over-the-counter, or away from regulated exchanges, compared to 41 percent in 1998.")

<sup>45</sup> *OTC Derivatives Oversight: Statement of the Securities and Exchange Commission*, U.S. COMMODITY FUTURES TRADING COMM'N, [http://www.cftc.gov/International/InternationalInitiatives/oia\\_otcderovst.html](http://www.cftc.gov/International/InternationalInitiatives/oia_otcderovst.html) (last visited October 10, 2010).

<sup>46</sup> Anti-Gold Futures Act, ch. 127, 13 Stat. 132 (1864).

<sup>47</sup> Greenspan, Government Regulation and Derivative Contracts, *supra* note 9.

<sup>48</sup> Anti-Gold Futures Act, 13 Stat. at 132.

<sup>49</sup> Greenspan, Government Regulation and Derivative Contracts, *supra* note 9.

<sup>50</sup> *Id.*

<sup>51</sup> Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. CIN. L. REV. 537, 564 (2009). It should be noted, however, that in 1914, Congress passed the Cotton Futures Act, which established a system for grading cotton and prohibiting all cotton futures contracts other than those specified in the Act. The Act was eventually declared unconstitutional because it was passed under Congress's taxing power, but did not originate in the House, and was then replaced by the Cotton Futures Act of 1916. See *Cotton Futures Act Called Void*, N.Y. TIMES, Oct. 14, 1915.

<sup>52</sup> Future Trading Act, ch. 86, 42 Stat. 187 (1921).



requirement.<sup>53</sup> The purpose of this regulation was to prevent market manipulation by requiring exchanges seeking a contract market designation to introduce anti-manipulation rules.<sup>54</sup> The twenty cent tax on non-contract market trades made it nearly impossible to make a profit, and therefore, the Act essentially coerced trades to be executed on designated contract boards.<sup>55</sup> Soon after the Act was passed, however, eight members of the Chicago Board of Trade sued, and the U.S. Supreme Court eventually declared the Act unconstitutional.<sup>56</sup>

In response to the Supreme Court's decision, Congress passed the Grain Futures Act of 1922.<sup>57</sup> The purpose of the Grain Futures Act was to regulate interstate transactions on grain futures exchanges.<sup>58</sup> Once again, the constitutionality of the Act was called into question, requiring another Supreme Court decision.<sup>59</sup> In distinguishing the two acts, the Court stated that:

The Grain Futures Act which is now before us differs from the Future Trading Act in having the very features the absence of which we held . . . prevented our sustaining the Future Trading Act. As we have seen in the statement of the case, the [Grain Futures Act] only purports to regulate interstate commerce and sales of grain for future delivery on boards of trade because . . . manipulation . . . [of these markets] . . . [has] become a constantly recurring burden and obstruction to [interstate] commerce. Instead, therefore, of being an authority against the validity of the Grain Futures Act, it is an authority in its favor.<sup>60</sup>

In the end, the Court held that the Act's emphasis on limiting price manipulation in the futures markets—an event which had the potential to adversely affect interstate commerce—was enough to make the Act constitutional under the commerce clause.<sup>61</sup>

The Grain Futures Act remained in effect until June 15, 1936, when Congress passed the Commodity Exchange Act

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<sup>53</sup> *Hill v. Wallace*, 259 U.S. 44, 45 (1921).

<sup>54</sup> *Id.* at 51.

<sup>55</sup> *Id.* at 71.

<sup>56</sup> *Id.* at 70. Ultimately, the Court determined that the grain futures contracts at issue were wholly intrastate transactions, and that the assessment of a twenty cent tax was an unconstitutional exercise of Congress' taxing power. *See id.* at 70–72.

<sup>57</sup> Grain Futures Act, ch. 369, 42 Stat. 998 (1922).

<sup>58</sup> In response to the Supreme Court's decision in *Hill v. Wallace*, Congress expressly limited the provisions of the Grain Futures Act to boards of trade and individuals conducting interstate transactions. *See id.* at § 3.

<sup>59</sup> *See Board of Trade of Chicago v. Olsen*, 262 U.S. 1 (1923).

<sup>60</sup> *Id.* at 32–33 (1923).

<sup>61</sup> *Id.* at 41–42.

(CEA).<sup>62</sup> The CEA, which has been amended numerous times over the past seventy-five years, created the Commodity Exchange Authority, a precursor agency to the CFTC.<sup>63</sup> The CFTC—an independent regulatory agency—was created in 1974 when Congress passed the Commodity Futures Trading Commission Act of 1974 (CFTCA).<sup>64</sup> With some minor exceptions, the CEA grants the CFTC exclusive jurisdiction over all commodity futures and commodity options contracts.<sup>65</sup>

At the beginning of the new millennium, Congress again passed a major piece of legislation amending the CEA. The Commodity Futures Modernization Act of 2000 (CFMA) divided the universe of commodities into three general categories; (1) agricultural commodities; (2) exempt commodities; and (3) excluded commodities.<sup>66</sup> This categorization was based on the apparent susceptibility of certain commodities to manipulation, with agricultural commodities seen as most vulnerable, exempt commodities as less vulnerable, and excluded commodities as the least vulnerable.<sup>67</sup>

With respect to agricultural commodities, the CEA specifically enumerates certain articles or goods as commodities.<sup>68</sup> In addition to these specified commodities, the

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<sup>62</sup> Commodity Exchange Act, ch. 545, 49 Stat. 1491 (1936) (current version at 7 U.S.C. §§ 1–17 (2006)).

<sup>63</sup> See *Records of the Commodity Futures Trading Commission*, NAT'L ARCHIVES, <http://www.archives.gov/research/guide-fed-records/groups/180.html> (last visited Oct. 7, 2010). See also Jerry W. Markham, *The Commodity Exchange Monopoly—Reform Is Needed*, 48 WASH. & LEE L. REV. 977, 982 (1991) (“Rather than being an independent federal agency, such as the SEC, the Commodity Exchange Commission was composed of the Secretaries of the Departments of Agriculture and Commerce and the Attorney General of the United States. Day-to-day regulation of the statute was given to the Secretary of Agriculture who assigned this duty to an agency within the department, the Commodity Exchange Authority.”).

<sup>64</sup> Commodity Futures Trading Commission Act, Pub. L. No. 93-463, 88 Stat 1389 (1974) (current version at 7 U.S.C. § 1 *et seq.* (2006)).

<sup>65</sup> 7 U.S.C. § 6c(b) (2006) provides that: “No person shall . . . enter into . . . any transaction involving any commodity regulated under this chapter which is of the character of, or is commonly known to the trade as, an ‘option’ . . . contrary to any rule, regulation, or order of the Commission . . .” § 2(a)(1)(A) provides that: “The Commission shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions [including options] involving contracts of sale of a commodity for future delivery . . .”

<sup>66</sup> Commodity Futures Modernization Act of 2000, H.R. 5660, 106th Cong. (2d sess. 2000).

<sup>67</sup> See H.R. 5660, 106th Cong. § 5a(b)(2)(B) (“A registered derivatives transaction execution facility may trade any contract of sale of a commodity for future trading . . . only if . . . (B) the underlying commodity has a deliverable supply that is sufficiently large that the contract is highly unlikely to be susceptible to the threat of manipulation . . .”).

<sup>68</sup> 7 U.S.C. § 1a(4) enumerates the following commodities:

[W]heat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all

term commodity also includes those articles, goods, services, rights, or interests “in which contracts for future delivery are presently or in the future dealt in.”<sup>69</sup> Therefore, an underlying interest that is not enumerated in the CEA may nonetheless be a statutory commodity under the Act if it can reasonably underlie a futures contract on a forward looking basis.

The CEA defines an exempt commodity to mean “a commodity that is not an excluded commodity or an agricultural commodity.”<sup>70</sup> The types of commodities that fit within this definition include oil, gas, electric power, and precious and base metals.<sup>71</sup>

Finally, the CEA identifies certain interests as excluded commodities, thereby giving further depth to the regulatory purview of the CFTC.<sup>72</sup> The definition of an excluded commodity is comprised of four subsections, and allows for trading of contracts based on an enumerated list of commercial or economic indices or rates, whether within the control of contracting parties or not, and whether these indices or rates are based on commodities that have no cash market.<sup>73</sup> The definition of an excluded commodity, therefore, appears to open the door to commodity futures or options contracts based on a wide variety of events that have an economic consequence.

other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice . . . .

<sup>69</sup> *Id.*

<sup>70</sup> § 1a(14).

<sup>71</sup> *Congress Re-Enacts Amendments to the Commodity Exchange Act*, LEGAL NEWS ALERT (Foley & Lardner LLP), June 26, 2008, available at [http://www.foley.com/publications/pub\\_detail.aspx?pubid=5059](http://www.foley.com/publications/pub_detail.aspx?pubid=5059).

<sup>72</sup> § 1a(13).

<sup>73</sup> The Act defines “excluded commodity” as:

(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;

(ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is—

(I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or

(II) based solely on one or more commodities that have no cash market;

(iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or

(iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is—

(I) beyond the control of the parties to the relevant contract, agreement, or transaction; and

(II) associated with a financial, commercial, or economic consequence.

*Id.*

## ii. SEC Regulation

As stated above, in order for the CFTC to retain sole jurisdiction over a particular derivatives contract, the contract must involve the sale or future delivery of a commodity.<sup>74</sup> In 1972, the Chicago Mercantile Exchange (CME) created the International Monetary Market (IMM) to offer futures contracts in foreign currencies.<sup>75</sup> The creation of the IMM began an explosion of derivatives for non-agricultural products. Because these products were not easily defined as commodities, it was not entirely clear that the CFTC retained jurisdictional authority over them. Some of these products either partially or entirely contain features of securities, over which the SEC has jurisdiction.

In 1934, Congress granted the SEC jurisdiction over all security options products when it passed the Securities Exchange Act (Exchange Act), and subjected options to the rulemaking authority of the SEC.<sup>76</sup> The SEC did not adopt any such rule until 1974, however, until after the creation of the Chicago Board of Options Exchange when it adopted Rule 9b-1.<sup>77</sup> Options trading after the adoption of Rule 9b-1 was on a “pilot basis” only in order for the SEC to learn about any potential problems that could cause harm to investors. Rule 9b-1, until it was repealed in 1975,<sup>78</sup> prohibited options trading on any exchange except in accordance with a plan regulating options trading approved by the SEC.<sup>79</sup> The SEC retains jurisdiction over security options trading to this day. Thus, the SEC retains sole or joint jurisdiction over security futures and security options products.<sup>80</sup>

Since the creation of the CFTC, the two agencies have often battled over which agency has jurisdiction over certain financial derivatives. These jurisdictional battles eventually led to the Shad-Johnson Jurisdictional Accord (accord).<sup>81</sup> The accord was

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<sup>74</sup> § 2(i).

<sup>75</sup> *From Water Street to the World—A Brief History of the Chicago Board of Trade and the Chicago Mercantile Exchange*, CME MAGAZINE, Summer 2007, available at <http://www.cmegroup.com/company/history/magazine/Summer2007/FromWaterStreetToTheWorld.html>.

<sup>76</sup> See 15 U.S.C. § 78i (2000).

<sup>77</sup> 17 C.F.R. § 240.9b-1 (1974).

<sup>78</sup> Jerry W. Markham & David J. Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741, 748 & n.34 (1982).

<sup>79</sup> See § 240.9b-1(a).

<sup>80</sup> See *Advisory on Dodd-Frank Act: New Rules for Derivatives*, COVINGTON & BURLINGTON LLP (July 21, 2010), <http://www.cov.com/files/Publication/f11bd6db-d8f2-46d1-b91b-da0b30a44157/Presentation/PublicationAttachment/88322576-8e12-48ab-8c61-daca964bb4e0/Dodd-Frank%20Act%20-%20New%20Rules%20for%20Derivatives.pdf>.

<sup>81</sup> The accord was codified in the Securities Act Amendments of 1982, Pub. L. No. 97-303, 96 Stat. 1409 (1982). It was the result of an agreement between the Commodity

an agreement reached between the Chairmen of SEC and CFTC to resolve a dispute concerning jurisdiction over securities-based derivatives.<sup>82</sup> Under the accord, the CFTC retained exclusive jurisdiction over all futures contracts and options on both futures contracts and physical commodities.<sup>83</sup> The CFTC was also given jurisdiction over options on foreign currencies not traded on national securities exchanges, and futures and options on futures on securities indexes and exempted securities.<sup>84</sup> The accord allowed the CFTC to approve a stock index futures contract for trading if it (1) was settled in cash; (2) not readily susceptible to manipulation; and (3) derived from a substantial segment of a publicly traded group or index of equity or debt securities, called broad-based indexes.<sup>85</sup> These contracts were also subject to initial SEC review for compliance with these requirements, and the SEC was given the authority to prohibit the trading of these contracts if the SEC determined that these requirements were not met.<sup>86</sup> Also under the accord, the SEC retained jurisdiction over securities, including options on securities, options on certificates of deposit, options on securities indexes, and options on foreign currency traded on a national securities exchange.<sup>87</sup> Because the two agencies could not resolve their jurisdictional differences with respect to single security futures contract, these contracts were banned for nearly twenty years until the CFMA

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Futures Trading Commission's Chairman, Phil Johnson, and the Securities and Exchange Commission's Chairman, John Shad, to clarify jurisdictional concerns between the two agencies and their respective products. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-00-89, CFTC AND SEC: ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD 6 (2000) [hereinafter CFTC AND SEC—ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD], available at <http://www.gao.gov/archive/2000/gg00089.pdf> ("First, [the accord] provided SEC with jurisdiction over securities-based options, including stocks and stock indexes. Second, the accord prohibited futures (and options thereon) on single corporate and municipal securities . . . . Finally, the accord provided CFTC with jurisdiction over futures (and options thereon) on exempted securities (other than municipal securities) and stock indexes. The accord allowed CFTC to approve a stock index futures contract for trading if CFTC found that the contract was (1) settled in cash; (2) not readily susceptible to manipulation; and (3) based on an index that either was a widely published measure of and reflected the market as a whole or a substantial segment of the market, or else was comparable to such a measure. According to SEC and CFTC, these three standards were intended to ensure that stock index futures would not be readily susceptible to manipulation, be used to manipulate the underlying securities or related options markets, or serve as a surrogate for a single stock futures contract.").

<sup>82</sup> See CFTC AND SEC—ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 81, at 5.

<sup>83</sup> *Id.* at 6.

<sup>84</sup> *Id.* at 6 & n.13 ("Exempted securities include securities issued or guaranteed by the United States, the District of Columbia, or any U.S. state.").

<sup>85</sup> *Id.* at 6.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

once again allowed trading of these instruments.<sup>88</sup> Today, regulation of security futures—instruments considered to be both securities and futures—is jointly shared by the CFTC and the SEC.

Despite the various amendments to the CEA and Exchange Act over the past thirty-five years, the jurisdictional battles between the CFTC and SEC have continued. At no time was this battle more intense than during the mid- to late-1990s, when the two agencies failed to agree on how to regulate OTC derivatives.<sup>89</sup> The CFMA failed to clarify jurisdictional authority over OTC derivatives—a decision that would ultimately haunt the U.S. and world financial markets in the years to come.

## 2. Over-the-Counter Derivatives Regulation

Following the sub-prime mortgage crisis and the ensuing financial collapse of 2008, calls were made by members of Congress, as well as consumer and investor protection groups, to regulate the OTC derivatives market. As stated previously, OTC contracts are entered into privately, off-exchange by parties. Because these are private contracts, the parties retain control over settlement and clearing. Despite the impact these instruments have on the U.S. and international economies, they remained largely unregulated by either the CFTC or the SEC.<sup>90</sup>

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<sup>88</sup> See 7 U.S.C. § 1a(32) (2000) (“The term ‘security futures product’ means a security future or any put, call, straddle, option, or privilege on any security future.”).

<sup>89</sup> See Ted Bunker, *Power Grab Threatens OTC Derivatives Market*, BOSTON HERALD, June 22, 1998, at 26; Willa E. Gibson, *Are Swap Agreements Securities or Futures? The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 J. CORP. L. 379, 388, 390–91 (1999) (“In December 1997, the SEC proposed a rule to allow broker-dealers selling OTC derivatives . . . to establish designated subsidiaries for their OTC transactions in the U.S. The designated subsidiaries would be allowed to register with the SEC as an alternative to registration as a fully regulated broker-dealer under Section 15(b) of the Exchange Act if they combine their business in securities and non-securities OTC derivatives products. . . . The CFTC responded . . . by stating that the proposed rule infringed upon the CFTC’s jurisdictional authority over OTC derivatives transactions . . . because only a small percentage of OTC derivatives were securities.”). Nonetheless, the rule took effect on January 4, 1999. *Id.*

<sup>90</sup> In a 1994 report by the U.S. Government Accountability Office (GAO), the director of the GAO (and U.S. Comptroller General) stated:

Given the weaknesses and gaps that impede regulatory preparedness for dealing with a crisis associated with derivatives, GAO recommends that Congress require federal regulation of the safety and soundness of all major U.S. OTC derivatives dealers. Regulators should attempt to prevent financial disruptions from turning into crises and resolve crises to minimize risks to the financial system . . . . The immediate need is for Congress to bring the currently unregulated OTC derivatives activities of securities firm and insurance company affiliates under the purview of one or more of the existing federal financial regulators and to ensure that derivatives regulation is consistent and comprehensive across regulatory agencies.

See GAO REPORT ON FINANCIAL DERIVATIVES, *supra* note 15, at 14.

The most infamous OTC derivative contract during the 2008 financial crisis was the credit default swap (CDS).<sup>91</sup> CDSs are bilateral contracts used to transfer risk between protection buyers and protection sellers.<sup>92</sup> As one recent commentator stated, “CDSs have provided an important tool for risk management. They enable banks and other financial institutions to hedge the credit risk of lending to corporations, in turn facilitating economic activity. Hedging credit risk arguably frees up funds to be lent elsewhere, making more capital available for financings, which can reduce the cost of borrowing.”<sup>93</sup> CDSs were invented by Wall Street Banks in the late 1990s, but the size of the market is estimated to have increased from a notional value of \$632 billion in 2001, to over \$54.6 trillion in notional value by mid 2008.<sup>94</sup>

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<sup>91</sup> See *Market Survey*, ISDA, <http://www.isda.org/statistics/pdf/ISDA-Market-Survey-annual-data.pdf> (last visited Nov. 8, 2010).

<sup>92</sup> David Mengle, *Credit Derivatives: An Overview*, FED. RES. BANK OF ATLANTA ECON. REV., Fourth Quarter 2007, at 1, available at [http://www.frbatlanta.org/filelegacydocs/erq407\\_mengle.pdf](http://www.frbatlanta.org/filelegacydocs/erq407_mengle.pdf).

<sup>93</sup> Janis Sarra, *Financial Market Destabilization and the Role of Credit Default Swaps: An International Perspective On The SEC's Role Going Forward*, 78 U. CIN. L. REV. 629, 632 (2009). The underlying debate regarding CDSs has existed for centuries. See Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm'n, Keynote Address at Markit's Outlook for OTC Derivatives Markets Conference (Mar. 9, 2010), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/opagensler-32.html> (“Though credit default swaps have existed for only a relatively short period of time, the debate they evoke has parallels to debates as far back as 18th Century England over insurance and the role of speculators. English insurance underwriters in the 1700s often sold insurance on ships to individuals who did not own the vessels or their cargo. The practice was said to create an incentive to buy protection and then seek to destroy the insured property. It should come as no surprise that seaworthy ships began sinking. In 1746, the English Parliament enacted the Statute of George II, which recognized that ‘a mischievous kind of gaming or wagering’ had caused ‘great numbers of ships, with their cargoes, [to] have . . . been fraudulently lost and destroyed.’ The statute established that protection for shipping risks not supported by an interest in the underlying vessel would be ‘null and void to all intents and purposes.’”).

<sup>94</sup> See Mengle, *Credit Derivatives*, *supra* note 92, at 7; *News Release: ISDA Mid-Year 2008 Market Survey Shows Credit Derivatives at \$54.6 Trillion*, INT'L SWAPS & DERIVATIVES ASS'N, INC. (Sept. 24, 2008), <http://www.isda.org/press/press092508.html>. For a criticism of the use of notional amount to measure privately negotiated derivatives, see *Enhancing Investor Protection and the Regulation of Securities Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2009) (testimony of Robert Pickel, Chief Executive Officer, International Swaps and Derivatives Association, Testimony Before the Committee on Banking), available at <http://www.isda.org/press/pdf/Testimony-of-Robert-Pickel031009.pdf> (“While using notional amount as a measurement tool for the size of the privately negotiated derivatives business has its benefits, it also has a major drawback. Notional amount greatly overstates the actual exposure represented by the CDS business. One reason for this is because a seller of protection often seeks to hedge its risk by entering into offsetting transactions. Using the example above, if the counterparty that sold \$10 million of protection wished to hedge its risk and buy protection, it too would enter into a \$10 million CDS contract. Thus, there are now two CDS contracts outstanding with a total notional amount of \$20 million. The reality is, however, that only \$10 million is at risk.”).

On July 21, 2010, the President of the United States signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act) into law.<sup>95</sup> Title VII of the Financial Reform Act—known as the Wall Street Transparency and Accountability Act of 2010 (WSTA)—confers jurisdiction of security-based swaps to the SEC, and all other swaps to the CFTC.<sup>96</sup> Security-based swaps are also added to the definition of a “security” in the Securities Act of 1933 and the Exchange Act.<sup>97</sup> As such, an offer or sale of a security-based swap by or on behalf of the issuer of the underlying security, its affiliate or underwriter is considered an offer or sale of the underlying security. There is no requirement that the SEC deem an owner of a security-based swap to be the beneficial owner of the underlying security, or that the security-based swap have “incidents of ownership comparable to direct ownership of the equity security.”<sup>98</sup> Both agencies share joint regulatory jurisdiction over “mixed swaps.”<sup>99</sup>

The WSTA requires that all swaps and security-based swaps be cleared, unless an exemption exists.<sup>100</sup> The CFTC and SEC may exempt a swap or security-based swap from clearing if: (1) the swap or security-based swap is not accepted for clearing by a derivatives clearing organization (DCO) or a clearing agency or (2) one party to the contract is not a dealer or major swap or security-based swap participant and that party does not meet the eligibility requirement of a DCO/clearing agency.<sup>101</sup> All derivatives clearing organizations are required to submit to the CFTC for prior approval any swaps the organization seeks to accept for clearing.<sup>102</sup> The CFTC or SEC can stay the clearing requirement of a swap or security-based swap that it has

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<sup>95</sup> H.R. 4173: *Dodd-Frank Wall Street Reform and Consumer Protection Act*, GOVTRACK.US, <http://www.govtrack.us/congress/bill.xpd?bill=h111-4173> (last visited Nov. 8, 2010).

<sup>96</sup> See H.R. 4173, 111th Cong. §§ 712(b)(1)–(2) (2010).

<sup>97</sup> §§ 761(a), 768(a) (amending 15 U.S.C. § 78c(a)(10) and 15 U.S.C. § 77b(a)(1), respectively).

<sup>98</sup> 15 U.S.C.S. § 78m(o) (LEXIS through P.L. 111-237).

<sup>99</sup> H.R. 4173 § 712(a)(8); 7 U.S.C.S. § 1a(49)(D) (LEXIS through P.L. 111-267) (“The term ‘security-based swap’ includes any agreement, contract, or transaction that is as described in section 3(a)(68)(A) of the Securities Exchange Act of 1934 (15 U.S.C. [§] 78c(a)(68)(A)) and also is based on the value of one or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.”).

<sup>100</sup> H.R. 4173 §§ 723(a), 763(a) (amending 7 U.S.C. § 2(e)(3) and 15 U.S.C. § 78a(3C)(a), respectively).

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*



approved for listing upon request of either party to the contract, or on its own, and must then determine within ninety days whether the product does or does not need to be cleared.<sup>103</sup> A product that the CFTC or SEC determines does not need to be cleared is still allowed to be cleared.<sup>104</sup>

The WSTA, therefore, creates a presumption that OTC swaps will be cleared through a CCP. Additionally, the WSTA requires both the CFTC and SEC to adopt rules requiring maintenance of records of uncleared swap and security-based swap transactions, respectively, to be made available to one another.<sup>105</sup> Thus, the new legislation confers whole or partial jurisdiction over most OTC swap transactions, which, along with the existing jurisdiction over futures and options by the CFTC and SEC, creates various degrees of regulatory regimes for nearly all derivative contracts.

By passing the WSTA, Congress took the opportunity to not only increase regulation of OTC derivatives, but also to address the potential for on-exchange trading of specific information aggregation derivative contracts; namely, contracts based on box office receipt numbers.

## II. DOMESTIC BOX OFFICE RECEIPT DERIVATIVE CONTRACTS

In 2008, in response to a substantial number of requests asking for guidance on the offering and trading of “information aggregation” financial contracts, the CFTC issued a concept release on the appropriate regulatory treatment of event based contracts.<sup>106</sup> As the CFTC’s release summarized:

These event contracts generally take the form of financial agreements linked to eventualities or measures that neither derive from, nor correlate with, market prices or broad economic or commercial measures. Event contracts have been based on a wide variety of interests including the results of presidential elections, the accomplishment of certain scientific advances, world population levels, the adoption of particular pieces of legislation, the outcome of corporate product sales, the declaration of war and the length of celebrity marriages.<sup>107</sup>

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<sup>103</sup> H.R. 4173 §§ 723(a), 763(a) (amending 7 U.S.C. § 6(c)(1) and 15 U.S.C. § 78a(3C)(i), respectively).

<sup>104</sup> *Id.*

<sup>105</sup> § 712(d)(1)–(3).

<sup>106</sup> Concept Release on the Appropriate Regulatory Treatment of Event Contracts, E8-9981, 73 Fed. Reg. 25669 (May 7, 2008) [hereinafter Concept Release on the Appropriate Regulatory Treatment of Events Contracts], *available at* <http://www.cftc.gov/LawRegulation/FederalRegister/e8-9981.html>.

<sup>107</sup> *Id.*

Among the reasons for issuing the concept release were to help determine: (1) whether event based contracts are within the CFTC's jurisdiction; (2) if the CFTC does, in fact, have jurisdiction over these contracts, whether there should be exemptions or exclusions applied to them; and (3) how to address potential gambling aspect of some of these contracts.<sup>108</sup>

#### A. Benefits of Information Markets

An event based market is generically known as an "information market."<sup>109</sup> An information market is a relatively simple operation. The market maker issues a security or derivative and specifies how these instruments will eventually be redeemed or settled.<sup>110</sup> The various instruments' payout will be based on objectively verifiable information at the time of redemption or settlement (e.g., whether the Federal Reserve changes the federal funds target rate).<sup>111</sup> Individuals who wish to participate in these markets purchase financial instruments from the market and subsequently trade these instruments (or purchase offsetting contracts in the case of derivatives) with one another.<sup>112</sup> The prices at which these transactions occur reflect market predictions of the eventual payout, and thus, whether the participants believe a certain event is likely to occur.<sup>113</sup>

Proponents of information markets point to the efficient markets hypothesis, which, in essence, states that it is impossible to beat the market because market efficiency causes the prices of financial instruments to immediately incorporate and reflect all relevant information.<sup>114</sup> In other words, stocks traded on a public exchange will always trade at their fair value, making it impossible for investors to purchase undervalued stocks or sell inflated stocks. Thus, the hypothesis maintains that it is impossible to outperform the overall market. In an efficient information market, the market price of the financial instrument will theoretically be the best indicator of whether an event will actually occur or not, and no combination of polling or other information gathering techniques can in any way improve upon the market generated forecasts. The advantage of having a price signal market for information is that the market aggregates the publicly and privately known information, as well as the

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<sup>108</sup> *Id.*

<sup>109</sup> Matthew Einbinder, *Information Markets: Using Market Predictions to Make Administrative Decisions*, 92 VA. L. REV. 149, 150 (2006).

<sup>110</sup> *Id.*

<sup>111</sup> *Id.* at 151.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> See Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1575 (1991).

tastes of a large number of participants, which produce judgments that incorporate more data than could be assembled centrally.<sup>115</sup>

In order for these markets to perform as advertised, though, market participants must trade rationally. Rational trading is certain to occur in these markets by virtue of the fact that market participants have a financial incentive to disclose their beliefs about future events. Unlike marketing research, polling, or other information gathering techniques, information market participants have no incentive to lie or conceal their beliefs. Additionally, individual positions in regulated information markets cannot be revealed. This means that market participants need not fear potential negative consequences of making their beliefs known—a fear that cannot necessarily be allayed in other types of group information gathering methods.

For some market participants, rational trading will also mean manipulation of the markets in an effort to increase the financial stake in their particular market positions.<sup>116</sup> For this reason, there is a clear need for market regulation, particularly anti-manipulation provisions. Anti-manipulation techniques take the form of financial disclosures to regulators and the markets themselves, as well as position and capital limits.<sup>117</sup> An information market, if regulated by the CFTC or SEC, would be subject to anti-manipulation provisions, which makes regulated markets more desirable than unregulated markets.

It should be equally clear that these types of markets are limited in how much information can be learned. For instance, a certain market may be able to accurately predict who will next be elected President, but does not have the capability to discern whether a particular policy assurance by a candidate is desired by the public.<sup>118</sup> This, of course, underpins one of the tenants of economics: that missing markets lead to inefficiency.<sup>119</sup>

The classic example of this theory was first analyzed fifty years ago by Nobel Prize winning economist Ronald Coase.<sup>120</sup> Imagine, for example, that a candy maker operates noisy

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<sup>115</sup> Cass R. Sunstein, *Group Judgments: Statistical Means, Deliberation, and Information Markets*, 80 N.Y.U. L. REV. 962, 1023 (2005).

<sup>116</sup> *Id.* at 1036.

<sup>117</sup> *Id.* at 1048.

<sup>118</sup> One could argue that a candidate's policy assurances are the reason that he or she is likely to be elected, but there is a difference between whether someone is likely to be elected, and whether the public agrees with a particular campaign promise.

<sup>119</sup> See, e.g., Tibor Scitovsky, *Two Concepts of External Economies*, 62 J. POL. ECON. 143, 144–50 (1954).

<sup>120</sup> Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

equipment next door to a doctor's office. The candy maker, by pursuing his own interests, is interfering with the doctor's examination of patients. While the candy maker derives benefits from his operation, the doctor surely suffers. Economists call this type of interference a negative externality, or as Coase put it, a social cost.<sup>121</sup> An unbiased observer may decide that the candy maker should merely shut down his business in order for the doctor to serve the welfare of the public. This overlooks the damage that such a solution would cause to the candy maker. The same is true, of course, were the onlooker to decide that the doctor should shut down his practice. Thus, there appears to be an impasse, or more precisely, an inefficiency given the fact that both individuals cannot operate their businesses side-by-side.

This dilemma can be solved, however, by the creation of a market. In such a market, the candy maker and doctor would determine how much money one would need to compensate the other with in order to close down their respective businesses. The eventual solution depends on the relative size of the gains and losses of the parties. Coase's example demonstrates that inefficiencies are caused by a lack of markets.<sup>122</sup> The take away, though, is that information markets have the potential to be very valuable resources, but enough markets must exist (or be allowed to exist) in order for significant amounts of information to be learned.<sup>123</sup> Although a single information market is inevitably an imperfect information discovery vehicle, there seems to be some consensus that contracts traded on these types of markets provide capable—if not highly accurate—predictive tools.<sup>124</sup>

#### B. Existing Event Based Markets

The Iowa Electronic Markets (IEM) is an electronic trading facility operated by the University of Iowa Henry B. Tippie College of Business that functions as an experimental and academic program, and is one of the better known real-money information markets currently in operation.<sup>125</sup> The IEM has been in existence since 1988, and operates in part pursuant to a 1993 no-action letter issued by the CFTC, which allowed the IEM to list various event contracts subject to certain conditions and

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<sup>121</sup> *Id.* at 2.

<sup>122</sup> *Id.* at 3–4.

<sup>123</sup> Sunstein, *supra* note 115, at 962.

<sup>124</sup> See, e.g., Michael Abramowicz, *Information Markets, Administrative Decisionmaking, and Predictive Cost-Benefit Analysis*, 71 U. CHI. L. REV. 933, 950 (2004).

<sup>125</sup> *About IEM*, UNIV. OF IOWA TIPPIC COLLEGE OF BUSINESS, <http://tippie.uiowa.edu/iem/about/index.html> (last visited Sept. 28, 2010).

limitations.<sup>126</sup> The IEM continues to be recognized for its presidential and congressional election contracts.<sup>127</sup> Currently, the IEM offers markets for 2010 Senate and House of Representatives “control,” as well as a Federal Reserve monetary policy market.<sup>128</sup>

In 2008, the IEM offered vote share and winner-take-all contracts for the U.S. presidential election cycle.<sup>129</sup> The vote share contract was associated with the candidates nominated by each party, with each contract having a maximum value of one dollar, and a contract payout “directly based on the percentage of the popular vote received by each of the two major party candidates.”<sup>130</sup> For instance, a contract for a candidate who received twenty-five percent of the popular votes cast for both candidates was worth twenty-five cents at settlement.<sup>131</sup> The winner-take-all contract, in contrast, had a value of either one dollar or nothing at settlement.<sup>132</sup> These contracts were also associated with a specific candidate, but “instead of having a payout tied to a particular percentage of the popular vote received by each candidate,” the contract “distributed a fixed payout of \$1 to its holder only if the referenced candidate receive[d] a greater percentage of the popular vote cast.”<sup>133</sup>

Another well-known event based market is the Hollywood Stock Exchange (HSX) which markets itself as the “world’s leading entertainment stock market.”<sup>134</sup> The HSX, which was founded in 1996, is now a subsidiary of Cantor Fitzgerald, L.P.—a financial services provider that offers clients financial products

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<sup>126</sup> Letter from Andrea M. Corcoran, Director, CFTC Division of Trading and Markets, to George R. Neumann, Professor of Economics, University of Iowa (June 18, 1993), available at <http://www.cftc.gov/files/foia/repfoia/foirf0503b004.pdf>. This no-action letter superseded a more limited letter issued to the IEM in 1992, and extends the CFTC’s no-action relief to contracts based on political elections, economic indicators, and certain currency exchange rates. *Id.* The letter requires that the IEM limit access to any one submarket to between 1,000 and 2,000 traders. *Id.* The letter also sets the maximum amount that any single participant can risk in any one submarket at \$500. The letter makes clear that relief is premised on, among other factors, the IEM’s representation that the market is being operated for academic purposes, and the assurance that the IEM will not receive any profit or other form of compensation from its activities. *Id.*

<sup>127</sup> *Current Markets*, UNIV. OF IOWA TIPPIE COLLEGE OF BUSINESS, <http://tippie.uiowa.edu/iem/markets/> (last visited Sept. 28, 2010).

<sup>128</sup> *Id.*

<sup>129</sup> Concept Release on the Appropriate Regulatory Treatment of Event Contracts, *supra* note 106.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*

<sup>134</sup> *About HSX*, HSX, <http://www.HSX.com/about/?page=index> (last visited Sept. 27, 2010).

and services in the equity and fixed income capital markets.<sup>135</sup> The HSX allows individuals to buy and sell virtual shares of celebrities and movies with a currency called the Hollywood Dollar.<sup>136</sup> The HSX is less of an information market than the IEM because participants are not using real money,<sup>137</sup> but it nonetheless provides a realistic framework for other—more authentic—information markets. Despite the faux nature of the HSX, it has proved to be a relatively accurate predictor of box office success or failure.<sup>138</sup> As one recent commentator noted, the “HSX offers good predictions of a film’s gross receipts before release and, relatively speaking, even better predictions after opening weekend—when a large number of traders have some information in the form of (or at least the possibility of) observing the finished film on screen, along with audience reactions.”<sup>139</sup> By not allowing participants to conduct real trading operations, the HSX avoids securities and derivatives regulation, while still allowing individuals to predict the success of films.<sup>140</sup>

While many individuals are interested in politics or Federal Reserve monetary policy, there are some who are undoubtedly more engrossed in the success or failure of major motion pictures. This, of course, was the thinking when Cantor Futures Exchange, L.P.—another subsidiary of Cantor Fitzgerald, L.P.—and Media Derivatives, Inc. applied for designation as contract markets in which individuals would be able to trade real domestic box office receipt derivatives.<sup>141</sup>

### C. The Purpose of DBOR Derivative Exchanges

Supporters of domestic box office receipt (DBOR) derivative exchanges claim that such markets will assist the motion picture industry by expanding the number of potential financing sources

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<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> This statement is based on the assumption that individuals will behave more rationally when their own money is at stake. Thus, an individual is less likely to merely guess or enter into riskier contracts which, while providing the potential for a larger payoff, are also less likely to actually payoff. See Emile Servan-Schreiber et al., *Prediction Markets: Does Money Matter?*, 14 ELECTRONIC MARKETS 243, 250 (2004), available at <http://bpp.wharton.upenn.edu/jwolfers/Papers/DoesMoneyMatter.pdf> (finding no difference in the predictive accuracy between real money and play money exchanges during the 2003 NFL football season).

<sup>138</sup> Saul Levmore, *Simply Efficient Markets and the Role of Regulation: Lessons from the Iowa Electronic Markets and the Hollywood Stock Exchange*, 28 J. CORP. L. 589, 593 (2003).

<sup>139</sup> *Id.*

<sup>140</sup> *Id.* at 592–93.

<sup>141</sup> See *infra* note 159.

available, as well as allowing film companies and investors to limit their risk.<sup>142</sup>

Historically, film companies raised financing through public or private sources, but the number of equity investors has decreased dramatically over the past thirty years.<sup>143</sup> One of the reasons for this decrease in capital is the risk involved in making a motion picture. Even though there are anywhere between 600 and 700 films produced each year, only about 200 of these obtain a release that could potentially lead to any sort of return, let alone a profit.<sup>144</sup> When a blockbuster does occur, though, it can make up for the losses on these other films.<sup>145</sup> Unfortunately, significant capital is required to make enough films to ensure that at least one studio film will be a blockbuster.

The most common film financing technique is known as a banking pre-sale.<sup>146</sup> This approach involves the assembly of a package involving a script, director, and key cast members.<sup>147</sup> Once the film package is complete, the producer engages an agent to pre-sell the film throughout the world at various film markets.<sup>148</sup> However, “[m]any films do not make it past the film markets.”<sup>149</sup> Pre-selling films has become more difficult, though, and distributors are now waiting until films are in production before committing to license them.<sup>150</sup> For those films that are financed, very few are done on an individual basis.<sup>151</sup> Film financiers generally engage in “slate financing,” whereby an investor finances a portfolio of future films, thus spreading around—and decreasing—the risk that an investor’s capital will be lost.<sup>152</sup> With slate financing, however, the investor does not

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<sup>142</sup> See Nikki Finke, *Worst Idea Ever? Wall Street Plans Futures Exchange Tied to Box Office*, DEADLINE N.Y. (Dec. 9, 2008, 11:23 AM), <http://www.deadline.com/2008/12/wall-stree-firm-planning-futures-exchange-tied-to-movie-sales/> (quoting a financial source explaining that such exchanges “could lead to another source of revenue for studios who can make their own bets on movies they are releasing to increase total revenue take or hedge losses”).

<sup>143</sup> Schuyler M. Moore, *Raising Film Financing by Betting the Box*, 24 ENTMT’L REP. 4, 4 (2003) [hereinafter Moore, *Raising Film Financing*].

<sup>144</sup> See Schuyler M. Moore, *Financing Drama*, L.A. LAW., May 2008, at 2 [hereinafter Moore, *Financing Drama*] (“Many events may cause films to lose money, such as budget overages, third-party claims, misappropriation and, of course, artistic failure.”).

<sup>145</sup> *Id.*

<sup>146</sup> *Id.* at 4.

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> *Id.*

<sup>150</sup> Moore, *Financing Drama*, *supra* note 144, at 4 (“Average worldwide presales have shrunk from about 100 percent of a film’s budget in the heyday of the financing technique to less than 70 percent today.”).

<sup>151</sup> *Id.* at 4–6.

<sup>152</sup> See Norbert Morawetz, *Finance, Policy and Industrial Dynamics The Rise of Coproductions in the Film Industry*, at n.xi (June 18–20, 2007), <http://www2.druid.dk/>

always know what films are being financed, and thus, the investor is essentially investing blind.<sup>153</sup>

Anyone who invests in a film project presumably does so with the expectation that the film (or slate of films) will provide a positive net return. Clearly, film financiers have an incentive to reduce their financial risk, which allows these individuals or companies to survive if a film flops. One of the most common ways to reduce risk is for film companies to enter into split-rights transactions, whereby two or more companies co-finance a film with one taking domestic rights, and the other taking foreign rights.<sup>154</sup> The downside to this type of contract is that when companies enter into contracts where profits are shared over two territories, the valuable distribution rights, and about half the profits, are given away to competitors. Nonetheless, this approach has become widespread despite the fact that film companies are in the business of owning and exploiting film rights.<sup>155</sup>

Film financing and hedging obviously go hand in hand. An individual or organization is more likely to invest in a film if assurances can be made that there will be a limit to the potential financial losses, while still providing for potential financial gains. The purpose of DBOR derivative markets, therefore, is to allow the parties with financial interests in a film's revenue stream to hedge against the risks associated with producing, distributing, financing, and insuring motion pictures.<sup>156</sup> The individuals and organizations potentially included in this group include: (1) owners of screenplays; (2) debt and equity investors in a particular film or slate of films; (3) film talent who either benefit directly from box office receipts or whose future career prospects depend on appearance in quality films; (4) studios who need a steady revenue stream to continue production if movie investment dries up; (5) insurers of film talent and movies; (6) theaters whose revenue stream depends on people purchasing tickets to see a film; (7) film distributors; and (8) promotional

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conferences/viewpaper.php?id=1671&cf=9 (explaining that, "[r]ather than relying on a single top-or-flop project, equity funds and studios use a portfolio approach to film financing where risk is spread across a slate of films") (citation omitted).

<sup>153</sup> Cyrus Sanati, *Movie Time at the C.F.T.C. Draws Heated Debate*, N.Y. TIMES BLOG (May 19, 2010, 4:04 PM), <http://dealbook.blogs.nytimes.com/2010/05/19/heated-debate-during-movie-time-at-the-c-f-t-c/>.

<sup>154</sup> Moore, *Raising Film Financing*, *supra* note 144, at 4.

<sup>155</sup> *Id.*

<sup>156</sup> See, e.g., Randall Dodd, Derivatives Study Ctr., Derivatives Markets: Sources of Vulnerability in U.S. Financial Markets, at 2 (Nov. 15, 2001), <http://www.financialpolicy.org/fpfspr8.pdf> (explaining that derivatives, in general, are used to "hedge the risks normally associated with commerce and finance").



marketing partners (e.g., fast food chains) who produce or sell products associated with particular films.

It should be noted that these individuals or organizations could *potentially* benefit from an exchange. This is not to say that these markets will actually be used by these individuals or organizations. Nonetheless, as stated earlier, when seeking the source of inefficiencies, one should look for missing markets, and allow potential participants to decide whether these products and markets are right for them.<sup>157</sup>

#### D. History of DBOR Derivative Exchanges

In 2008, Cantor Futures Exchange, L.P. (Cantor) and Media Derivatives, Inc. (MDEX)<sup>158</sup> applied for designation as contract markets in which individuals and organizations would be able to trade DBOR derivative contracts.<sup>159</sup> The process of creating an exchange on which derivatives are traded can be broken down into two main parts: (1) designation of the exchange as a contract (or other type) of market, and (2) approval of the contracts proposed for trading on the exchange.

##### 1. CFTC Approval of DBOR Markets

When the CEA was amended in 2000 by the Commodity Futures Modernization Act (CFMA), a three-tiered market framework was created.<sup>160</sup> Since the enactment of the Grain Futures Act in 1922, the CFTC, or its precursor agencies, have regulated exchanges known as designated contract markets

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<sup>157</sup> At a May 19, 2010 hearing before the CFTC, Clark Hallren and Alice Neuhauser stated that they are not aware of any OTC derivative market where the contracts are linked to box office receipts. Opponents of DBOR derivatives would suggest that the lack of an OTC market tends to indicate that no one would use a DBOR exchange. The flip side of this argument is that the lack of an OTC market could mean that a potential party is merely unable to find a counterparty for its desired contract. Additionally, one benefit that an exchange has over an OTC market is that exchanges and regulators are required to keep individual positions confidential. During this same hearing, CFTC Commissioner Gary Gensler acknowledged that about seventy percent of all contracts submitted to the CFTC for trading approval fail due to lack of trading volume. See *Live Blogging! The CFTC Public Meeting on Movie Box Office Futures*, JABCAT ON MOVIES (May 19, 2010), <http://jabcatmovies.com/2010/05/live-blogging-the-cftc-public-meeting-on-movie-box-office-futures>.

<sup>158</sup> In correspondence with the CFTC dated May 20, 2010, MDEX changed its name to Trend Exchange, Inc. This article, however, will continue to refer to this entity as MDEX.

<sup>159</sup> See Application for DCO Registration of Cantor Fitzgerald, L.P. (Nov. 25, 2008), <http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/cantordcoapplicationletter.pdf>; Media Derivatives, Inc. Background Paper (August 2009), <http://www.cftc.gov/ucm/groups/public/@rulesandproducts/documents/ifdocs/mdex092509b.pdf>.

<sup>160</sup> See *supra* note 66.

(DCMs).<sup>161</sup> DCMs “may list for trading futures or option contracts based on any underlying commodity, index or instrument.”<sup>162</sup> However, in addition to DCMs, the CFMA created less regulated organized markets known as derivatives transaction execution facilities (DTEF).<sup>163</sup> The CFMA also authorized the creation of “exempt boards of trade”<sup>164</sup> (exempt boards) and “excluded electronic trading facilities” (EETF).<sup>165</sup> The exempt board and EETF provisions of the CFMA provided a means for establishing trading facilities for certain derivative transactions (e.g., energy, metal, chemical, and emissions futures) that remain largely outside the scope of the CFTC’s regulatory authority, with the exception that exempt boards remain subject to the anti-fraud and anti-manipulations prohibitions of the CEA.<sup>166</sup> EETFs, however, are not subject to these prohibitions.<sup>167</sup>

DCMs remain subject to strict regulatory requirements by the CFTC.<sup>168</sup> Specifically, the CFMA amended the CEA to require entities requesting a contract market designation to demonstrate that it meets eight designation criteria,<sup>169</sup> and

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<sup>161</sup> *History of the Current Regulatory Framework*, STA UNIV., <http://www.stauniversity.org/content/History%20of%20the%20Current%20Regulatory%20Framework%20-%20Futures%20Regulation.pdf> (last visited Nov. 8, 2010).

<sup>162</sup> *Designated Contract Markets*, U.S. COMMODITY FUTURES TRADING COMM’N, <http://www.cftc.gov/IndustryOversight/TradingOrganizations/DCMs/index.htm> (last visited Sept. 28, 2010).

<sup>163</sup> Susan C. Ervin Dechert, *CFTC Regulation of Energy Derivatives: An Overview* (Aug. 13, 2002), <http://www.abanet.org/buslaw/corporateresponsibility/clearinghouse/02annual/37/erwin.pdf>.

<sup>164</sup> 7 U.S.C. § 7a-3(b) (2000). Transactions conducted on an exempt board must be between eligible contract participants. Permissible transactions for an exempt board of trade are limited to transactions “for which the underlying commodity has: (A) a nearly inexhaustible deliverable supply; (B) a deliverable supply that is sufficiently large, and a cash market sufficiently liquid, to render any contract traded on the commodity highly unlikely to be susceptible to the threat of manipulation; or (C) no cash market.” *Id.* Transactions on an exempt board are subject to the anti-fraud and anti-manipulation provisions of the CEA. *See* § 7a-3(c).

<sup>165</sup> § 2(d)(2). The CEA does not apply to contracts (i) entered into only by eligible contract participants trading on a principal-to-principal basis or in certain investment management or fiduciary capacities, and (ii) done so on an electronic trading facility. *See id.*

<sup>166</sup> *Congress Makes Changes to the Regulation of Futures and Derivatives Transactions*, MCDERMOTT WILL & EMERY (Jan. 2001), [http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object\\_id/EAB1D60E-C2CE-47DC-BEB4-2D6B543759878.cfm](http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/EAB1D60E-C2CE-47DC-BEB4-2D6B543759878.cfm).

<sup>167</sup> *Id.*

<sup>168</sup> *See* § 7(d).

<sup>169</sup> § 7(b). The eight designation criteria are: (1) general demonstration of adherence to designation criteria; (2) prevention of market manipulation; (3) fair and equitable trading; (4) enforcement of rules on the trade execution facility; (5) financial integrity of transactions; (6) disciplinary procedures; (7) public access to information on the contract market; and (8) ability of the contract market to obtain information. *Id.*

complies with eighteen core principles.<sup>170</sup> The CEA requires that the CFTC approve or deny a designation application within 180 days of the filing of the application.<sup>171</sup> If the CFTC denies the application, it must specify the grounds for the denial.<sup>172</sup> Following a refusal to designate an applicant as a contract market, the CFTC must provide the applicant with an opportunity for a hearing on the record before the CFTC.<sup>173</sup> A DCM applicant thereafter has a right to appeal an adverse decision directly to a federal appeals court.<sup>174</sup> Despite designating over fifty DCMs over the years, as of December 2010, the CFTC oversaw only seventeen DCMs where trading was active or anticipated.<sup>175</sup>

In addition to amending the requirements for achieving a contract market designation, the CFMA created less regulated DTEFs. DTEFs are subject to a less comprehensive body of core principles than contract markets,<sup>176</sup> but in exchange for this less stringent regulatory oversight, are limited in the types of contracts it can offer and the types of parties who are allowed to participate in the transactions.<sup>177</sup> There are currently no DTEFs regulated by the CFTC.<sup>178</sup>

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<sup>170</sup> § 7(d)(1)–(18). The eighteen core principles contract markets are subject to include: (1) general adherence to these core principles; (2) compliance with the rules; (3) listing of products not subject to manipulation; (4) monitoring of trading; (5) position limits; (6) emergency authority; (7) disclosure of information; (8) trading data dissemination; (9) execution of transactions; (10) trade information maintenance; (11) financial integrity; (12) protection of market participants; (13) dispute resolution; (14) fitness standards; (15) conflicts of interest; (16) governance of mutually owned markets; (17) recordkeeping; and (18) antitrust considerations. *Id.*

<sup>171</sup> § 8(a). The CEA also contains a provision for staying the running of the 180-day time limit when an exchange is notified that the application for contract market designation is materially incomplete, and provides the Commission with at least sixty days for review once the application has been resubmitted in completed form. *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*

<sup>174</sup> 5 U.S.C. § 706(2) (Supp. II 1965).

<sup>175</sup> *Trading Organizations*, U.S. COMMODITY FUTURES TRADING COMM'N, <http://services.cftc.gov/SIRT/SIRT.aspx?Topic=TradingOrganizations&implicit=true&type=DCM&CustomColumnDisplay=TTTTTTTTT> (last visited Dec. 1, 2010) [hereinafter *Trading Organizations*].

<sup>176</sup> § 7a(d)(2)–(9). The eight core principles for DTEFs are subject to include: (1) compliance with rules; (2) monitoring of trading; (3) disclosure of information; (4) daily publication of trading information; (5) fitness standards; (6) conflicts of interest; (7) recordkeeping; and (8) antitrust considerations. *Id.*

<sup>177</sup> *See* § 7a(b). If access to a DTEF is limited to eligible commercial entities trading for their own accounts, the DTEF may permit trading involving any commodity other than an agricultural commodity, and if access to a DTEF is not so limited, transactions are restricted to contracts where:

(A) the underlying commodity has a nearly inexhaustible deliverable supply; (B) the underlying commodity has a deliverable supply that is sufficiently large that the contract is highly unlikely to be susceptible to the threat of manipulation; (C) the underlying commodity has no cash market; (D)(i) the contract is a security futures product and (ii) the [DTEF] is [also registered as

EETFs and exempt boards, as stated above, were largely exempted from the CFTC's regulatory authority by the CFMA, and therefore these entities need not comply with any designation criteria or core principles.

On April 16, 2010 and April 20, 2010, respectively, the CFTC approved MDEX and Cantor's applications for registration as DCMs.<sup>179</sup> The CFTC noted that MDEX and Cantor's applications did not include any proposed DBOR derivative contracts to be traded on the exchanges, but rather, the approval was based on the proposed general operations of the exchanges.<sup>180</sup> Further, the CFTC observed that the general operations of the exchanges may not be appropriate for all types of DBOR contracts, because certain contracts may require special surveillance or compliance measures.<sup>181</sup> For this reason, the CFTC ordered MDEX and Cantor to not only ensure the appropriateness of particular products for trading on the exchanges, but also required the two exchanges to submit to the CFTC any contracts that the two exchanges anticipate listing on the exchanges for prior approval.<sup>182</sup>

By requiring prior approval of DBOR contracts, the CFTC impeded MDEX and Cantor from conducting any business. As stated previously, registration as a DCM is only half of an exchange's battle. Without products to list, a DCM is analogous to a doctor without patients.

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a national securities exchange] . . . ; [or] (E) the [CFTC] determines, based on the market characteristics, surveillance history, self-regulatory record and capacity of the facility that trading in the contract (or option) is highly unlikely to be susceptible to the threat of manipulation . . . .

*Id.*

<sup>178</sup> *Trading Organizations*, *supra* note 175.

<sup>179</sup> Order of Designation as a Contract Market by the U.S. Commodity Futures Trading Comm'n at 2, In re Request of Media Derivatives, Inc. (Apr. 16, 2010) [hereinafter MDEX Order of Designation as a Contract Market], *available at* <http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/mdexorder041510.pdf>; Order of Designation as a Contract Market by the U.S. Commodity Futures Trading Comm'n at 1, In re Request of Cantor Futures Exchange, L.P., (Apr. 20, 2010) [hereinafter Cantor Order of Designation as a Contract Market], *available at* <http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/cantorfuturesexchangeorder.pdf>.

<sup>180</sup> MDEX Order of Designation as a Contract Market, *supra* note 179, at 2; Cantor Order of Designation as a Contract Market, *supra* note 179, at 3–4.

<sup>181</sup> *Application for Contract Market Designation Compliance with Designation Criteria and Core Principles*, U.S. COMMODITY FUTURES TRADING COMM'N, <http://www.cftc.gov/ucm/groups/public/@requestsandactions/documents/ifdocs/cantordcmcompliancechart.pdf>.

<sup>182</sup> MDEX Order of Designation as a Contract Market, *supra* note 179, at 2; Cantor Order of Designation as a Contract Market, *supra* note 179, at 4.

## 2. CFTC Approval of DBOR Products

Even before the CFTC designated MDEX and Cantor as contract markets, both exchanges submitted proposed contracts for listing on their respective exchanges.<sup>183</sup> On March 9, 2010, MDEX requested prior CFTC approval to list an opening weekend DBOR futures and binary option<sup>184</sup> contract on the motion picture *Takers*.<sup>185</sup> On March 30, 2010, Cantor requested approval to trade derivatives contracts on its DCM for the motion picture *The Expendables*.<sup>186</sup>

In addition to creating a three-tiered framework for derivative markets, the CFMA also amended the CEA's listing requirements by now allowing exchanges to choose between listing contracts pursuant to a self-certification procedure, or pursuant to a prior review procedure by the CFTC.<sup>187</sup> By filing a self-certification, an exchange certifies that the contract complies with the CEA, and is required to submit the certification documents to the CFTC no later than one business day before initial implementation of the product listing.<sup>188</sup> The CFMA made it possible, therefore, for trading to occur on contracts that are subsequently banned by the CFTC, merely by self-certifying the contract in good faith. On the other hand, if prior approval of a contract is sought, the exchange must submit to the CFTC the contract's terms and conditions, and demonstrate compliance with CFTC regulations.<sup>189</sup> Products submitted for prior approval are subject to a forty-five day review period, with the potential for a forty-five day extension if the product raises a "novel or complex" issue.<sup>190</sup>

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<sup>183</sup> MDEX Order of Designation as a Contract Market, *supra* note 179, at 1; Cantor Order of Designation as a Contract Market, *supra* note 179, at 1.

<sup>184</sup> A binary option "is a type of options trading where the payoff is either some fixed amount of some asset or nothing at all." *Binary Options Trading*, 1 ANYOPTION, <http://www.lanyoption.com/tag/binary-option-trading/> (last visited Sept. 30, 2010). Thus, options that are binary in nature allow for only two possible outcomes. For example, an individual purchases a binary call option on XYZ, Inc.'s stock with a strike price of \$75 and a binary payoff of \$500. If, on or before the maturity date, the stock trades at \$75 or above, the purchaser of the option receives \$500. If the stock expires before reaching \$75 or more, the purchaser receives nothing and is out the option premium.

<sup>185</sup> See *Statement of the Commission*, U.S. COMMODITY FUTURES TRADING COMM'N, June 14, 2010 [hereinafter *Statement of the Commission*], available at <http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/mdexcommissionstatement061410.pdf>.

<sup>186</sup> See *Request by Cantor Exchange For Review and Approval of the The Expendables Futures Contract*, U.S. COMMODITY FUTURES TRADING COMM'N, June 28, 2010, available at <http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/cantorfuturesdbororder062810.pdf>.

<sup>187</sup> 7 U.S.C. § 7a-2(c) (2000).

<sup>188</sup> See 17 C.F.R. § 40.6 (2009).

<sup>189</sup> 17 C.F.R. § 40 app. A.

<sup>190</sup> 17 C.F.R. § 40.3.

Given the relatively novel nature of these contracts, the CFTC required MDEX and Cantor to submit proposed contracts to the CFTC for prior approval before trading.<sup>191</sup> On May 19, 2010, the Commission held a public hearing to consider issues related to the trading of DBOR futures and binary options.<sup>192</sup> As the Commission noted during this meeting, the CEA provides that the CFTC must approve a contract submitted for prior approval within ninety days, unless it finds that the contract violates the CEA.<sup>193</sup> As stated earlier, the CEA grants the CFTC jurisdiction over contracts for the sale of a commodity for future delivery and over commodity option contracts traded on DCMs, and therefore, the CFTC, in reviewing MDEX and Cantor's applications for prior approval of their DBOR contracts, was required to determine whether the underlying subject of these contracts was a commodity.<sup>194</sup>

i. CFTC's Finding that DBORs are Commodities

The CFMA separated the universe of commodities into three categories: (1) agricultural commodities; (2) exempt commodities; and (3) excluded commodities.<sup>195</sup> In the order approving MDEX's DBOR contract, the CFTC noted that "[m]ovie revenues fall into the same category as many other commodities for which futures and options contracts have been either approved by or self-certified to the Commission where the underlying commodity is a non-price-based measure of an economic activity, commercial

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<sup>191</sup> Dan M. Berkovitz, General Counsel, Commodity Futures Trading Comm., Remarks at Public Meeting to Consider the Trading of Contracts Based on Motion Picture Box Office Receipts and Gather Views of Interested Parties (May 19, 2010) [hereinafter Berkovitz Remarks], available at [www.cftc.gov/ucm/groups/public/@newsroom/documents/title/transcripts051910](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/title/transcripts051910).

<sup>192</sup> For an archived webcast of this meeting, see *Consideration of the Trading of Contracts Based on Motion Picture Box Office Receipts*, U.S. COMMODITY FUTURES TRADING COMM'N, <http://capitolconnection.net/capcon/cftc/webcastarchive.htm#> (last visited Sept. 14, 2010).

<sup>193</sup> 7 U.S.C.A. § 7a-2(c)(3) (West 2009) (requiring the CFTC to "approve any such new contract or instrument . . . unless the Commission finds that the new contract or instrument . . . would violate this chapter"); 17 C.F.R. § 40.3(b)-(c) ("All products submitted for Commission approval . . . shall be deemed approved . . . forty-five days after receipt . . . . The Commission may extend the forty-five day review period . . . for: (1) [a]n additional forty-five days, if the product raises novel or complex issues . . . ."); 17 C.F.R. § 40.3(d) ("The Commission . . . may notify the submitting entity that it will not, or is unable to, approve the product or instrument.").

<sup>194</sup> *Statement of the Commission*, *supra* note 185, at 2 n.3 ("In the great majority of new product reviews, the answer to this question is obvious and requires no explicit analysis. However, such a determination was made prior to Commission approval of the Chicago Mercantile Exchange's single-name Credit Event contracts.").

<sup>195</sup> Commodity Futures Modernization Act of 2000, H.R. 5660, 106th Cong. (2d sess. 2000); Jayashree B. Gokhale, *Hedge to Arrive Contracts: Futures of Forwards*, 53 DRAKE L. REV. 55, 56 n.3 (2004).

activity or environmental event.”<sup>196</sup> The Commission has found that such a commodity is a right or interest within the meaning of section 1(a)(4) of the CEA:<sup>197</sup> “While the right or interest may be intangible, it can clearly serve as the basis for a futures or options contract.”<sup>198</sup>

The Commission’s order did not explicitly say which of the three categories of commodities DBORs fall under, but the language of the order makes it apparent that box office receipts fall under the category of excluded commodities.<sup>199</sup> The CEA defines an excluded commodity as “an occurrence . . . associated with a financial, commercial, or economic consequence.”<sup>200</sup> Despite the fact that the CFTC had never previously dealt with DBOR derivative contracts, the Commission’s order acknowledged that more than five hundred similarly excluded commodity contracts were submitted to the CFTC for prior approval or self-certified since the CFMA was enacted.<sup>201</sup>

#### ii. DBOR Contracts Do Not Appear to be Subject to Manipulation

Having passed the threshold issue of whether DBORs are commodities, the CFTC addressed the issue of whether these DBOR derivative contracts satisfied the core principles established by the CFMA.

Under the third core principle of the CEA, in order to maintain its standing, a DCM is required to list “only contracts that are not readily susceptible to manipulation.”<sup>202</sup> Unlike state and federal securities laws, U.S. derivative regulations do not make insider trading unlawful. Nonetheless, prior to approving MDEX’s contracts, the Commission insisted that modifications be made to the contract proposal to ensure that knowledgeable parties cannot intentionally release or misreport data that would have an impact on the trading or settlement of this contract.<sup>203</sup>

Because DBOR contracts are cash-settled (as opposed to physically delivered), the Commission must be sure that the settlement price upon which these contracts are based is not subject to manipulation. The vast majority of DBOR numbers

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<sup>196</sup> *Statement of the Commission, supra* note 185, at 3.

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> *Id.* at 4.

<sup>200</sup> 7 U.S.C. § 1a(13)(iv) (2000).

<sup>201</sup> *Statement of the Commission, supra* note 185, at 3 (“More than 500 of these types of contracts have been approved by or self-certified to the Commission to date.”).

<sup>202</sup> 7 U.S.C. § 7(d)(3) (2000).

<sup>203</sup> *Statement of the Commission, supra* note 185, at 4–5.

are reported by Rentrak Corporation (Rentrak) and disseminated throughout the film industry.<sup>204</sup> Rentrak is a third-party data aggregator and does not have a direct monetary interest in any motion picture.<sup>205</sup> Essentially, Rentrak transfers box office revenue numbers from movie theaters to distributors.<sup>206</sup> These numbers are used mostly by film studios as marketing tools (e.g., advertising a film as the number one grossing movie at the box office). Since 2008, Rentrak has collected more than ninety-eight percent of all box office revenue numbers, with the remaining box office numbers being delivered directly from theaters to distributors.<sup>207</sup> Because the majority of data is automated, there is little opportunity for “misrepresentation or distortion of the numbers reported to Rentrak by the theaters.”<sup>208</sup> The Commission found that the price basis for DBOR contracts (i.e., Rentrak’s numbers) are quite similar to other commodity pricing data (e.g., energy contracts that rely on data from commercial index providers and agricultural contracts that rely on data provided by the U.S. Department of Agriculture), and therefore, do not appear susceptible to manipulation.<sup>209</sup>

### iii. DBOR Contracts Provide a Reasonable Hedging Device

Although repealed by the CFMA, the CEA used to require CFTC staff to apply an economic purpose test when evaluating proposed DCM contracts.<sup>210</sup> Specifically, the economic purpose test only allowed trading of contracts that would “not be contrary to the public interest.”<sup>211</sup> The CFTC, in interpreting this section, found that a contract that was not contrary to the public interest must serve a legitimate hedging purpose.<sup>212</sup>

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<sup>204</sup> *Id.* at 5.

<sup>205</sup> *Id.*

<sup>206</sup> *Id.*

<sup>207</sup> *Id.* at 5–6 (known as “call around” data).

<sup>208</sup> *Id.* at 6.

<sup>209</sup> *Id.* at 6–7.

<sup>210</sup> *See id.* at 9.

<sup>211</sup> 7 U.S.C. § 7(g) (1974) (“When such board of trade demonstrates that transactions for future delivery in the commodity for which designation as a contract market is sought will not be contrary to the public interest.”).

<sup>212</sup> Concept Release on the Appropriate Regulatory Treatment of Event Contracts, *supra* note 106, at 25672 (“The public interest test . . . included an ‘economic purpose’ test, subject to a final test of the public interest. The economic purpose test . . . was used to prohibit the trading of certain contracts. Notably, the economic purpose test regarding contracts appropriate for trading on a futures exchange was not necessarily congruent with the scope of the Commission’s jurisdiction. Accordingly, while futures contracts that failed the economic purpose test were prohibited from trading on futures exchanges and thus illegal because of the on-exchange trading requirement, they (and any instrument with identical terms) remained futures contracts, fully subject to the Commission’s jurisdiction.”).



Despite the repeal of the economic purpose test, the findings and purpose section of the CEA, as amended by the CFMA, finds that transactions subject to the CEA have a significant impact on the public interest because they provide a “means for managing and assuming price risks.”<sup>213</sup> The CFTC recognized in its order that some commentators have suggested that the findings and purpose section of the CEA reestablishes an economic purpose test.<sup>214</sup> Nonetheless, because the economic purpose test was repealed by the CFMA, the Commission declined to adopt the test in determining whether to approve DBOR derivative contracts.<sup>215</sup>

Despite declining to apply the pre-CFMA economic purpose test, the CFTC did evaluate whether MDEX’s DBOR contracts would provide some reasonable means for managing risks associated with box office revenues.<sup>216</sup> In conducting its analysis, the Commission assessed the risks faced by individuals associated with box office revenues.<sup>217</sup> The Commission noted that “[f]ilm production requires a significant amount of upfront capital with long lead times to completion. In addition, film financing can involve pre-selling in the form of office space leases for construction and transactions with foreign distributors or television providers.”<sup>218</sup> In order to deal with these risks, film studios have been required to rely on third party financial investors.<sup>219</sup> In light of public comments and written testimony submitted to the CFTC, the Commission believed that third party investors would potentially utilize DBOR futures to mitigate their commercial exposure.<sup>220</sup> The Commission also agreed with the authors of many public comment letters who stated that DBOR contracts “would provide a risk management

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<sup>213</sup> 7 U.S.C. § 5(a) (2000) (“The transactions subject to this chapter are entered into regularly in interstate and international commerce and are affected with a national public interest by 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.”).

<sup>214</sup> *Statement of the Commission, supra* note 185, at 9. At the May 19th hearing on DBOR derivatives, CFTC General Counsel, Dan Berkovitz, stated that:

[I]n 2000 . . . [Congress] . . . took out the public interest test, but . . . we believe that within the findings and purposes [section of the CEA] together with the requirement that the Commission find that and not be violative of the Act that there still is authority within the statute for the Commission . . . [to reject a contract] . . . in a circumstance where the Commission would believe that the contract would violate the finding and the purpose of the Act . . . .

Berkovitz Remarks, *supra* note 191, at 78–79.

<sup>215</sup> *Statement of the Commission, supra* note 185, at 9–10.

<sup>216</sup> *Id.* at 10.

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *Id.*

<sup>220</sup> *Id.* at 10–11.

tool or expressed interest in using the contracts for hedging.”<sup>221</sup> Those authors “stated that direct participants in the motion picture industry, such as studios and producers, may benefit from having motion picture revenue futures contracts.”<sup>222</sup>

In light of the Commission hearing on DBOR contracts and the public comments submitted to the CFTC, the Commission approved MDEX’s DBOR contract on the movie *Takers* for trading on its DCM on June 14, 2010, and Cantor’s DBOR contract on the movie *The Expendables* on June 28, 2010.<sup>223</sup> Approval by the CFTC on MDEX’s contracts, however, was short lived.<sup>224</sup> Once the Financial Reform Act was signed into law by the President, trading of DBOR derivatives became a banned activity.<sup>225</sup>

#### E. Ban on DBOR Exchange Products

As stated earlier, the Financial Reform Act was passed in response to the financial collapse of 2008, and imposed sweeping changes to the U.S. financial regulatory system, including the regulation of derivatives.<sup>226</sup> Among these changes was the joint regulation of the previously unregulated OTC swap market by the SEC and CFTC.<sup>227</sup>

The Wall Street Transparency and Accountability Act (WSTA), in addition to increasing regulation over swaps, banned trading of box office derivatives.<sup>228</sup> Specifically, the Act amended the definition of a commodity in the CEA to include an enumerated list of agricultural commodities

and all other goods and articles, except onions . . . and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion

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<sup>221</sup> *Id.* at 11.

<sup>222</sup> *Id.*

<sup>223</sup> *Id.* at 11–12 (approving MDEX’s product request); *Statement of the Commission*, U.S. COMMODITY FUTURES TRADING COMM’N, June 28, 2010, at 1, available at <http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/dborcommissionstatemnt0622810.pdf> (approving Cantor’s futures contract on *The Expendables*).

<sup>224</sup> Paul Harris, *House-Senate Committee Bans Futures Trading: MPAA ‘Heartened’ With Decision; Major Blow to Exchange Companies*, VARIETY (Jun. 25, 2010, 10:29 AM), <http://www.variety.com/article/VR1118021065.html?categoryid=13&cs=1>.

<sup>225</sup> *Id.*

<sup>226</sup> *Times Topics: Financial Regulatory Reform*, N.Y. TIMES, [http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit\\_crisis/financial\\_regulatory\\_reform/index.html](http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit_crisis/financial_regulatory_reform/index.html) (last updated Jul. 21, 2010).

<sup>227</sup> Wall Street Transparency and Accountability Act of 2010, H.R. 4173, 111th Cong. §§ 712(a)–(b) (2010), available at <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf> (dividing jurisdiction over security-based swaps with the SEC and all other swaps with the CFTC).

<sup>228</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 721(a)(4), 124 Stat. 1376, 1659 (2010).

picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in.<sup>229</sup>

In changing the definition of a commodity, Congress, without conducting a hearing on the issue prior to drafting the Financial Reform Act,<sup>230</sup> banned trading of all DBOR derivatives.<sup>231</sup> Beginning in 1864 with the Anti-Gold Futures Act, Congress has occasionally attempted to ban trading of derivatives on specific commodities and other underlying instruments. As of December 2010, however, DBORs—along with onions—were the only two commodities on which Congress deemed it unlawful to trade derivative contracts.<sup>232</sup>

### 1. Previous Bans on Specific Derivative Contracts

As mentioned previously, Congress' first attempt at derivatives regulation occurred on June 17, 1864, when it passed the Anti-Gold Futures Act.<sup>233</sup> The Act made it unlawful to enter into any futures contract for the purchase of gold coin, gold bullion, or foreign exchange.<sup>234</sup> The Act had the unintended consequence of leading to the further decline in the value of the Union's "fiat currency," and was repealed a mere two weeks after

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<sup>229</sup> 7 U.S.C.S. § 1a(4) (LEXIS, through P.L. 111-237).

<sup>230</sup> On April 22, 2010, the House Agriculture Subcommittee on General Farm Commodities and Risk Management held a hearing on DBOR derivatives. See Press Release, House Agric. Comm., Subcommittee Reviews Proposed "Movies Futures" Market (Apr. 22, 2010), available at [http://agriculture.house.gov/list/press/agriculture\\_dem/PR042210GFCRM.html](http://agriculture.house.gov/list/press/agriculture_dem/PR042210GFCRM.html). However, the ban on DBOR contracts in the Financial Reform Act was originally drafted by the Senate Agriculture and Senate Banking, Housing, and Urban Affairs Committees. The Financial Reform Act passed by the Senate on May 20, 2010 was required to be reconciled with the Wall Street Reform and Consumer Protection Act of 2009, which was passed by the House on December 11, 2009. The original House bill did not include a ban on DBOR derivatives, and the House Agriculture Subcommittee hearing on this issue did not take place until after the bill was passed. House Agriculture Committee Chairman, Collin C. Peterson, who did attend the House Agriculture Subcommittee on DBOR contracts, as well as House Agriculture Subcommittee on General Farm Commodities and Risk Management Chairman Leonard Boswell, were members of the joint House-Senate conference committee in charge of reconciling the Financial Reform Act. Reps. Peterson and Boswell, as far as this author can tell, were the only individuals on the conference committee who attended the House Agriculture Subcommittee hearing. See generally *Hearing to Review Proposals to Establish Exchanges Trading "Movie Futures": Hearing Before the Subcomm. on General Farm Commodities and Risk Management of the H. Comm. on Agriculture*, 111th Cong. (2010); *House Conferees Appointed on H.R. 4173*, U.S. HOUSE OF REPRESENTATIVES, [http://financialservices.house.gov/FinancialSvcsDemMedia/file/key\\_issues/Financial\\_Regulatory\\_Reform/Conferees\\_List\\_Final.pdf](http://financialservices.house.gov/FinancialSvcsDemMedia/file/key_issues/Financial_Regulatory_Reform/Conferees_List_Final.pdf) (last visited Sept. 14, 2010).

<sup>231</sup> See Harris, *supra* note 224.

<sup>232</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, § 721(a)(4).

<sup>233</sup> Greenspan, Government Regulation and Derivative Contracts, *supra* note 47.

<sup>234</sup> Anti-Gold Futures Act, ch. 127, 13 Stat. 132, (1864).

it was passed.<sup>235</sup> It would be nearly a century before Congress once again banned trading on a specific commodity future.<sup>236</sup>

When Congress passed the CEA in 1936, it imposed an absolute ban on options for regulated commodities.<sup>237</sup> Until the CEA was amended by the CFTCA in 1974, there existed no restrictions on the trading of options on unregulated commodities.<sup>238</sup> On September 21, 1981, however, the CFTC adopted a comprehensive set of regulations to govern exchange-trading of options on futures contracts under a controlled and monitored three-year pilot program, and on February 15, 1985, the CFTC approved the first option on a physical commodity: gold bullion.<sup>239</sup> Commodity options, which are now fully regulated by the CFTC, can be traded on DCMs if the exchange meets the prior approval or self-certification requirements of the CEA.<sup>240</sup>

Perhaps the most pervasive manipulation of the commodity markets between the years of 1930 and 1970 took place in the onion markets.<sup>241</sup> As a result of the severe price swings in onions, the CEA was amended in 1955 to give the Commodity Exchange Authority power to regulate trading in onion futures.<sup>242</sup> In 1956, Congress gave consideration to prohibiting trading in onion futures, with hearings being held before the House Agriculture Committee, which concluded that there was a causal relationship between trading onion futures and

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<sup>235</sup> Jenny Wahl, *Give Lincoln Credit: How Paying for the Civil War Transformed the United States Financial System*, 3 ALB. GOV'T L. REV. 700, 725 n.109; Greenspan, Government Regulation and Derivative Contracts, *supra* note 47.

<sup>236</sup> David S. Jacks, *Populists Versus Theorists: Future Markets and the Volatility of Prices*, 44 EXPLORATIONS ECON. HIST. 342, 353 (2007) (discussing the passage of the Onion Futures Act in 1958).

<sup>237</sup> Commodity Exchange Act, ch. 545, sec. 4c(3)(B), 49 Stat. 1491, 1494 (1936).

<sup>238</sup> 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM THE AGE OF DERIVATIVES TO THE MILLENNIUM (1970–2001) 44 (2002).

<sup>239</sup> *History of the CFTC*, U.S. COMMODITY FUTURES TRADING COMM'N <http://www.cftc.gov/About/HistoryoftheCFTC/index.htm> (last visited Oct. 11, 2010).

<sup>240</sup> *Proposals to Establish Exchanges Trading "Movie Futures:" Hearing Before the S. Comm. on General Farm Commodities & Risk Mgmt., House Comm. on Agric.* 111th Cong. 6–7 (2010) (testimony of Dan M. Berkovitz, General Counsel, U.S. Commodity Futures Trading Commission), available at <http://agriculture.house.gov/testimony/111/no42210/Berkovitz.pdf>.

<sup>241</sup> See, e.g., Vincent W. Kosuga, 19 Agric. Dec. 603, 603 (1960) (highlighting that the Commodity Exchange Authority alleged upward manipulation of spot market onion prices and onion futures contracts for November and December of 1955 on the CME, and further alleging downward manipulation of spot market onion prices and onion futures contracts for January and February of 1956 on the CME); BOB TAMARKIN, THE NEW GATSBYS: FORTUNES AND MISFORTUNES OF COMMODITY TRADERS 29 (1985) ("Hardly a day passed, it seemed, without somebody trying to corner the onion market or squeeze prices higher or push them lower.").

<sup>242</sup> Act of Jul. 26. 1955, Pub. L. No. 174, 69 Stat. 375 (1955).

fluctuations in the cash price of onions.<sup>243</sup> The Committee recommended that “futures trading be prohibited if the futures market could not be operated so as to prevent injury to onion producers.”<sup>244</sup> The same recommendation was made by the Senate Committee on Agriculture and Forestry, which stated that:

[B]ecause speculative activity in the futures market was apparently adversely affecting cash onion prices, Congress added onions to the commodities subject to regulation under the Commodity Exchange Act . . . . This has not cured the situation . . . [and i]t now appears that speculative activity in the futures markets causes such severe and unwarranted fluctuations in the price of cash onions as to require complete prohibition of onion futures trading in order to assure the orderly flow of onions in interstate commerce.<sup>245</sup>

As a result of the Senate and House Committee recommendations, on August 28, 1958, Congress passed the Onion Futures Act, which banned trading of futures contracts on onions.<sup>246</sup> Until 2010, the passage of the Onion Futures Act was the only time since the Anti-Gold Futures Act that Congress imposed an outright ban on a specific commodity futures contract.<sup>247</sup> Although there had been previous attempts to ban futures contracts on other commodity exchanges, these bills had been ultimately unsuccessful due to lobbying by congressional constituents with agricultural interests.<sup>248</sup>

Even though the subject underlying single security futures contracts are not commodities, the most recent ban on a specific derivative contract prior to the ban on DBOR derivative contracts stemmed from the failure of the CFTC and SEC to agree on how these instruments were to be regulated.<sup>249</sup> The divergent opinions of the two agencies led to the Shad-Johnson Jurisdictional Accord, which banned trading of single security

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<sup>243</sup> See *Chicago Mercantile Exchange v. Tiekens*, 178 F. Supp. 779, 781–83 (N.D. Ill. 1959).

<sup>244</sup> *Id.*

<sup>245</sup> *Id.*

<sup>246</sup> See 7 U.S.C. § 13-1(a) (1958).

<sup>247</sup> Jacks, *supra* note 236.

<sup>248</sup> See, e.g., Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 YALE J. ON REG. 279, 329 n.165 (1997) (discussing the lobbying efforts of onion and potato farmers in the 1950s). See also William H. Jones, *Church Introduces Plan to Ban Trading of All Potato Futures*, WASH. POST, Feb. 3, 1977, at D11 (quoting Senator Frank Church as saying, “[t]ime and time again, potato producers from across the nation have indicated that they have no desire to have trading in futures. They are tired of being the innocent victims of economic power plays by . . . spectators”); *History of the CFTC*, *supra* note 239 (noting that on July 21, 1964, Sen. Edmund Muskie introduced a bill to ban potato futures, but the bill did not become law).

<sup>249</sup> CFTC AND SEC—ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 81, at 5.

futures contracts for nearly twenty years.<sup>250</sup> This ban was eventually lifted, though, when Congress passed the CFMA, and today single security futures are jointly regulated by the CFTC and SEC.<sup>251</sup>

Despite attempts over the years to ban specific commodity derivative contracts, the only current commodities on which it is unlawful to trade derivatives are onions and DBORs.<sup>252</sup> While there has been little support to allow trading of onion futures over the last half-century, the ban on DBOR derivatives merely stems from poor timing.

### III. THE CASE FOR DBOR DERIVATIVE CONTRACTS

It is not entirely clear what Congress' intent was behind specifically banning DBOR derivative contracts in the Financial Reform Act. One can assume, however, that after the sub-prime mortgage crisis and the financial sector fallout in 2008, investors and elected officials became extremely wary about the use of derivatives. As the historical portion of this Article details, however, derivatives have been traded in the United States since 1849.<sup>253</sup> While these instruments were originally used as hedging devices for individuals and organizations involved in the agricultural sector, in the 1970s, derivatives began to be used by financial institutions, and the character of these devices expanded.<sup>254</sup>

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<sup>250</sup> Shad-Johnson Jurisdictional Accord, Pub. L. No. 97-303, 96 Stat. 1409, 1409–10 (1982) (codified at 7 U.S.C. § 2a(ii)(II–III) (1994)). See also 7 U.S.C. § 2(C)(i–ii)(I–III) (2006) (“the Commission shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities (as defined in section 77b(1) of title 15 or section 3(a)(10) of the Securities Exchange Act of 1934 [15 U.S.C. § 78c(a)(10)] on January 11, 1983), including any group or index of such securities, or any interest therein or based on the value thereof”); Sanford A. Fine, *Back To the (Single Stock) Future: The New Regulatory Framework Governing Single-Stock Futures Trading*, 54 ADMIN. L. REV. 513, 515 n.8 (2002) (noting that 7 U.S.C. § 2a(ii)(II–III) (1994) codifies “a portion of the Shad-Johnson Accord concerning the prohibition on trading futures on an individual security or in a narrow-based index”); CFTC & SEC—ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD, *supra* note 81, at 5–6 (“These three CEA amendments led to a dispute between SEC and CFTC that was eventually resolved through the Shad-Johnson Jurisdictional Accord. . . . [T]he accord prohibited futures (and options thereon) on single corporate and municipal securities.”).

<sup>251</sup> Dean Kloner, *The Commodity Futures Modernization Act of 2000*, 29 SEC. REG. L.J. 286, 293 (2001).

<sup>252</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1659, § 721(a)(4) (2010) (to be codified at 7 U.S.C. § 1a).

<sup>253</sup> Gary Gensler, *History of Derivative Regulation, Culprit OTCs*, COMMODITYONLINE, (July 2, 2010, 3:35 PM), <http://www.commodityonline.com/news/History-of-derivatives-regulation-culprit-OTCs-29636-3-1.html>; Dodd, *supra* note 156, at 1.

<sup>254</sup> See EUGENE F. BRIGHAM & MICHAEL C. EHRHARDT, FINANCIAL MANAGEMENT: THEORY AND PRACTICE 822 (Jack W. Calhoun et al. eds., 12th ed. 2008); FINANCIAL CRISIS

Many people analogize the trading of derivatives to gambling.<sup>255</sup> This suggestion could not be further from the truth, however. As Nobel prize winning economist Vernon L. Smith stated, “[g]ambling involves the deliberate creation of artificial zero-sum opportunities to engage in risk taking decisions that redistribute existing resources.”<sup>256</sup> Professor Smith continued, “[DBOR derivative contracts] are in the class of variable-sum stock and derivatives’ markets in which information on the future outcome of productive and technological activities is dispersed, uncertain, and rendered valuable to society when aggregated into prices [such as agricultural commodities].”<sup>257</sup> While some may find it difficult to understand what a DBOR futures contract has in common with a wheat futures contract, the fact remains that both of these instruments provide individuals with opportunities to hedge their financial risk.<sup>258</sup>

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INQUIRY COMM’N, PRELIMINARY STAFF REPORT OVERVIEW ON DERIVATIVES 3 (2010), available at <http://www.fcic.gov/reports/pdfs/2010-0630-psr-derivative-overview.pdf>; Rob Kirby, *Understanding Derivatives to Understand the Credit Crisis*, MARKET ORACLE (Oct. 20, 2008, 5:23 PM), <http://www.marketoracle.co.uk/Article6890.html>; Thomas F. Siems, *10 Myths About Financial Derivatives*, CATO INSTITUTE, (Sept. 11, 1997), <http://www.cato.org/pubs/pas/pa-283.html>.

<sup>255</sup> Shahien Nasiripour, *Derivatives Just “A Sophisticated Form Of Gambling,” U.S. Senators Say; Propose Bill Allowing State Gambling Laws To Apply*, HUFFINGTON POST (last updated Nov. 10, 2009, 11:24 PM), [http://www.huffingtonpost.com/2009/11/10/derivatives-just-a-sophis\\_n\\_352994.html](http://www.huffingtonpost.com/2009/11/10/derivatives-just-a-sophis_n_352994.html) (“In describing the complex and little-understood world of derivatives trading as ‘a sophisticated form of gambling,’ three U.S. Senators proposed legislation that would enable state gambling regulators and attorneys general to examine the practice.”); Jane D’Arista & Gerald Epstein, *Congress Should Force Big Banks to Stop Gambling With Our Money*, ALTERNET (May 10, 2010), [http://www.alternet.org/economy/146806/congress\\_should\\_force\\_big\\_banks\\_to\\_stop\\_gambling\\_with\\_our\\_money/](http://www.alternet.org/economy/146806/congress_should_force_big_banks_to_stop_gambling_with_our_money/) (“The derivatives business is straight gambling.”).

<sup>256</sup> Public Comment of Vernon L. Smith in Response to Concept Release on the Appropriate Regulatory Treatment of Event Contracts (May 7, 2008), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/frcomment/08-004c001.pdf>.

<sup>257</sup> *Id.*

<sup>258</sup> For a discussion on the benefits of wheat futures contracts, see Mark B. Major & Alan May, *MontGuide: The Futures Hedge (Short Hedge)*, MONT. STATE UNIV. (Dec. 2009), <http://msuextension.org/publications/AgandNaturalResources/MT200919AG.pdf> (noting that a wheat futures (short) hedge can be beneficial because, “[b]y locking in the futures price on the futures market, downside price risk is eliminated”); Mykel Taylor et al., *Hedging v. Forward Contracting for Wheat*, AGMANAGER.INFO (September 2003), <http://www.agmanager.info/marketing/publications/marketing/forwardcontracting.asp> (“When the cash price at harvest is higher than the expected price (i.e., price increases), the loss in the [wheat] futures market reduces the actual price received. When the price at harvest is lower than the expected price (i.e., price decreases), the gain in the [wheat] futures market offsets the loss in the cash market and thus increases the actual price received. It is this variation in price from which the producer is protected by hedging in the futures market.”). For a discussion on the benefits of DBOR futures contracts, see Dr. Kris, *Movie Futures Face Big Questions*, SEEKING ALPHA, (March 8, 2010), <http://seekingalpha.com/article/192390-movie-futures-face-big-questions> (“[A] company’s movie futures will create liquidity and provide studios with a hedging mechanism besides making the little guy an active participant.”); Ryan Pertz, *Fast Forward: Distributing Film Risk*, NEWBIZVIEWS (Apr. 28, 2010), <http://www.newbizviews.com/2010/04/28/fast>

Film companies, like any other commercial entity (e.g., a farmer) must sell what they produce at a profit in order to continue to exist as a viable business. Film companies specifically are in the business of selling successful films.<sup>259</sup> Unfortunately, if film companies fail to produce enough successful films, they will not be long for the industry.<sup>260</sup> To put it in economic terms, a film company has an incentive to produce quality films. Because film companies have this incentive, one could certainly envision a situation where such an entity would take a long position in a film futures contract. If a film company truly believed in their film, there would be no reason not to take such a position, because they would, in essence, have the opportunity to “double down”<sup>261</sup> on their product. Not only would the film company generate revenue from the initial sale of the movie, but if the movie generated enough box office receipts, the film company would earn even more money when it collected on its long positions.

On the flip side, film financiers, distributors, and theaters generate their revenue from box office receipts.<sup>262</sup> Thus, in order for these individuals and companies to remain viable, enough revenue must be generated at the box office to at least break even. Because there is always the risk that a film will “flop,” these individuals and companies would enter into a short position to hedge against this risk. If a film failed to produce

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forward-distributing-film-risk/ (“Like commodity forwards, movie futures can serve a practical purpose: they could enable the primary risk bearers (movie financiers in this case) to distribute a portion of their risk.”).

<sup>259</sup> See Shannon McCoy, *The Government Tunes in to Tune Out the Marketing of Violent Entertainment to Kids: The Media Violence Labeling Act, The Media Marketing Accountability Act and the First Amendment*, 4 VAND. J. ENT. L. & PRAC. 237, 245 (2002) (“Film studios promote and advertise films to make money, not merely to express themselves artistically.”).

<sup>260</sup> See Moore, *Financing Drama*, *supra* note 144, at 26.

<sup>261</sup> This author is fully aware that he is using a gambling phrase in an article that tries to dispel the myth that derivatives are nothing more than a form of gambling.

<sup>262</sup> Aljean Harmetz, *Where Movie Ticket Income Goes*, N.Y. TIMES (Jan. 28, 1987), available at <http://www.nytimes.com/1987/01/28/movies/where-movie-ticket-income-goes.html> (“The distributor of a movie—the studio that releases a film to theaters—usually ends up with less than fifty percent of the money paid for tickets.”); Mark Litwak, *Protecting Film Investors*, MARK LITWAK’S ENTMT LAW RESOURCES, [http://www.marklitwak.com/articles/general/protecting\\_film\\_investors.html](http://www.marklitwak.com/articles/general/protecting_film_investors.html) (last visited Oct. 2, 2010) (“[A]n intelligent investment in a motion picture can earn substantial returns. While film investments are risky, the potential return from a hit can be enormous. No [sic] only can the film earn revenue from box office receipts, but there are many ancillary sources of income.”); Sarah Morgan, *10 Things Movie Theaters Won’t Tell You*, YAHOO! FINANCE (Dec. 31, 2009), [http://finance.yahoo.com/family-home/article/108494/things-theaters-wont-tell-you?mod=family-kids\\_parents](http://finance.yahoo.com/family-home/article/108494/things-theaters-wont-tell-you?mod=family-kids_parents) (“[G]enerally speaking, theaters pay somewhere between 35 and 70 percent of box office receipts to the studio as a film-rental fee . . . . In most cases, the studio takes the biggest cut in the first week, and the percentage drops from there.”).



enough revenue at the box office to equal these entities' investments, the settlement on their DBOR contracts would, in theory, provide the capital necessary to allow the entities to break even.

If the long and short positions of these individuals and organizations are in balance, enough liquidity would be available in these markets to encourage others (e.g., marketing partners, minor investors, film talent, speculators) to buy and sell these same contracts. A DBOR market, which would clearly provide information about the expected success or failure of a film, would allow commercial and speculative investors to rebalance their particular positions as needed.

Movie studios may argue that no incentive exists for them to short a movie because filmmakers would decide never to work with that studio again; the theory being that if a studio does not believe a film will produce sufficient box office revenue, it must not believe in the quality of a filmmaker's work. This, of course, is the basis for the natural long position of the studios. However, as stated earlier, only about one-in-three films are expected to have the potential to come close to breaking even.<sup>263</sup> Thus, even if a studio did short its own film because it did not believe sufficient box office revenue would be generated, filmmakers would never know about this position because DCMs and the CFTC are kept anonymous.<sup>264</sup>

As the CFTC observed in its order approving MDEX's DBOR contract, DBOR numbers—the majority of which are prepared automatically by Rentrak—are not subject to manipulation.<sup>265</sup> The small percentage of call-around data,<sup>266</sup> even if it were attempted to be manipulated by the theaters or studios, would have a *de minimis* effect on the settlement data for these futures

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<sup>263</sup> Moore, *Financing Drama*, *supra* note 144, at 26.

<sup>264</sup> 7 U.S.C.A. § 6g(b) (West 2009) ("Every registered entity shall maintain daily trading records. The daily trading records shall include such information as the Commission shall prescribe by rule."); § 12(a)(1) (stating that, "except as otherwise specifically authorized in this chapter, the Commission may not publish data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers").

<sup>265</sup> *Statement of the Commission*, *supra* note 185, at 5–6.

<sup>266</sup> See Richard Shilts, Director, Division of Market Oversight on Meeting of the Commodity Futures Trading Commission to Discuss: Futures and Binary Options Based on Box Office Receipts, (May 19, 2010), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/shiltstatement051910.html> ("A small amount of box office receipts are not reported through Rentrak; they are reported directly from those theatres to the distributor. This data is referred to as call-around data. Once the distributor sums the Rentrak and call-around receipt data, that number is reported back to Rentrak which in turn distributes it to Variety Magazine, BoxOfficeMojo.com, and other news organizations and interested parties.").

contracts.<sup>267</sup> Assuming *arguendo* that Rentrak's numbers could potentially be manipulated, there would be no incentive for Rentrak to do so because it has no direct interest in DBOR numbers.<sup>268</sup> The fact that DBOR settlement prices are linked to a third party index is no different from agricultural commodity derivative contracts (e.g., feeder cattle futures which are linked to USDA indices).<sup>269</sup> The reputation of Rentrak, like the USDA, is important, however. Rentrak numbers have been a marketing tool that film studios have used for more than twenty years.<sup>270</sup> It is highly unlikely that Rentrak would start falsifying DBOR numbers now. The price basis for DBOR contract settlement, therefore, is not in question, and Congress, like the CFTC, should not be concerned about the potential for inaccurate settlement of these contracts.

Perhaps the greatest reason for allowing DBOR derivatives trading is the potential increase in capital that would flow into the film industry. As noted earlier, film financing has begun to dry up over the past few decades.<sup>271</sup> This is directly correlated to the risk associated with financing a film.<sup>272</sup> If investors could be assured that they would be able to hedge this risk, they would certainly be more likely to invest in the film industry.<sup>273</sup> Additionally, by increasing the amount of capital available to the film industry, the number of motion pictures exported from the U.S. would increase.<sup>274</sup> The potential for increased film financing, along with the ability for individuals and organizations whose revenue streams are directly tied to DBORs, is reason enough for Congress to repeal the ban on DBOR derivatives and allow trading of these contracts.

#### CONCLUSION

Whether DBOR derivative contracts fail due to lack of interest should be left to the exchange participants to decide, not

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<sup>267</sup> *Id.* at 6.

<sup>268</sup> *Id.*

<sup>269</sup> *See id.* at 6–7.

<sup>270</sup> *See About Rentrak*, RENTRAK CORP., <http://www.rentrak.com/section/corporate/about/index.html> (last visited Sept. 14, 2010).

<sup>271</sup> Moore, *Raising Film Financing*, *supra* note 143, at 4.

<sup>272</sup> *Id.*

<sup>273</sup> Moore, *Financing Drama*, *supra* note 144, at 26.

<sup>274</sup> *See, e.g.*, NAT'L EXPORT INITIATIVE, REPORT TO THE PRESIDENT ON THE NATIONAL EXPORT INITIATIVE: THE EXPORT PROMOTION CABINET'S PLAN FOR DOUBLING U.S. EXPORTS IN FIVE YEARS 40 (2010), available at [http://www.whitehouse.gov/sites/default/files/nei\\_report\\_9-16-10\\_full.pdf](http://www.whitehouse.gov/sites/default/files/nei_report_9-16-10_full.pdf) (outlining recommendations for doubling U.S. exports over the next five years). Given the emphasis on increasing U.S. exports, it seems curious to this author that legislation potentially limiting the number of exports—which is what could potentially occur to feature films by banning box office derivatives—would be enacted.

Congress. DBORs, along with onions, are the only commodities on which derivatives trading is currently unlawful. When onion futures were banned in 1958, however, it was the result of a three year long process that included hearings before multiple congressional committees.<sup>275</sup> DBOR contracts, however, had the simple misfortune of poor timing. Were it not for the sub-prime mortgage crisis and the resulting economic fallout, it is unlikely that Congress would have given the CFTC's decision to allow trading of DBOR derivatives a second thought. Nonetheless, Congress—who clearly arrived late to the table—decided that simply because DBOR derivatives are similar to the CDSs that helped lead to the economic collapse in 2008, they deserved to be banned. This is undoubtedly the wrong approach to take. Unfortunately, the ban on DBOR derivatives may be a sign of things to come. In an environment where the vast majority of new derivative exchanges and contracts are highly regulated by the CFTC and SEC, congressional stifling of financial innovation is both unnecessary and potentially harmful to a financial industry that could lose future markets to international competitors.

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<sup>275</sup> See *90 Years of Blood, Sweat and Onions*, ONION WORLD, (July/Aug. 2003), <http://www.columbiapublications.com/onionworld/julyaug2003.htm#ow29> (“In the 1950s those of the onion industry contended with futures trading on the Chicago Merchantile Exchange . . . . In the December 1955 [National Onion Association] annual meeting, a resolution was passed to eliminate futures trading . . . . The [National Onion Association] was the vehicle that moved the U.S. Congress to pass law that would ban futures trading . . . . Seven bills were presented to Congress to have it discontinued, countless letters were written in opposition and members of the industry traveled to Washington, D.C., to appear before congressional committees. Futures trading was officially banned in 1958.”); *History of the CFTC*, *supra* note 239 (noting that following a complaint regarding the manipulation of onion futures in 1956, “Congress held hearings to consider banning onion futures trading . . . . [In 1958 t]he Onion Futures Act ban[ned] futures trading in onions”).