Secretary of the Commission
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

July 24, 2023

Re: KalshiEX LLC - Commission Regulation 40.2(a) Notification Regarding the Initial Listing of the "Will <chamber of Congress> be controlled by <party> for <term>?" Contract ["Control Contract"]

The Institute for Agriculture and Trade Policy ("IATP")[1] appreciates the opportunity to comment on the Kalshi proposal of June 12[2] and to respond to a few of the Commission's questions about it.[3] First, we give an overview of why the Commission should not approve the Control Contract, a contract that would allow betting on which major party controls the majority of seats in one or both chambers of the U.S. Congress following each federal election. Then we respond to a few of the Commission's questions.

Overview

IATP commented on Kalshi's 2022 proposal for a similar Control Contract.[4] The publicly available documentation for evaluating the proposal's consistency with the Commodity Exchange Act and the CFTC's Core Principles was scant. The lack of publicly available documentation for this Control Contract is not a small matter for a proposal that must show that trading the contract is not "contrary to the public interest." (17 CFR, Sec. 40.11). The regulation on "Listing products for trade by certification" (17 CFR, Sec. 40.2)[5] requires the designated contract market to include in its submission to the Commission:

> "A concise explanation and analysis of the product and its compliance with applicable provisions of the Act, including core principles, and the Commission's

[1] IATP is a nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minnesota, with offices in Washington, D.C. and Berlin, Germany. IATP participated in the Commodity Markets Oversight Coalition (CMOC) from 2009 to 2015, and the Derivatives Task Force of Americans for Financial Reform since 2010.

[2] https://www.cftc.gov/sites/default/files/filings/ptc/23/06/ptc0612232834.pdf

[3] https://www.cftc.gov/PressRoom/PressReleases/8728-23

[4] https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=70791&SearchText=

[5] https://www.govinfo.gov/content/pkg/CFR-2022-title17-vol1/xml/CFR-2022-title17-vol1-sec40-2.xml

> regulations thereunder. This explanation and analysis shall either be accompanied by the documentation relied upon to establish the basis for compliance with applicable law, or incorporate information contained in such documentation, with appropriate citations to data sources;" [para 3. subpara v]

Kalshi's explanation and analysis, at two pages, is indeed concise. However, "Further information about the Contract, including an analysis of its risk mitigation and price basing utility, as well as additional considerations related to the Contract, is included in Confidential Appendices."[6] The public, lacking access to the Confidential Appendices, is constrained to analyze the "General Terms and Conditions" of the proposal, in addition to responding to the Commission's questions.

The "General Terms and Conditions" do not inspire confidence that the Control Contract is consistent with the CEA, the Core Principles and Commission regulations. Kalshi claims disingenuously that "The Contract operates similar to other event contracts that the Exchange lists for trading."[7] However, the Control Contract is only superficially "similar" to other Kalshi event contracts. For example, the contract certified by Kalshi on July 18, 2023, "Will the SAG strike end by <date>?", allows market participants, with no minimum order requirement, to take positions up to $25,000, betting on when the Screen Actors Guild strike will end against the owners of streaming services, cable networks and television production companies.[8] The SAG event contract, like Kalshi's other event contracts, are mostly directed towards retail investors. For example, Kalshi's website instructs how you can receive $25 for referring a friend to its platform who trades a certain amount in an event contract within a certain time frame.[9]

However, Kalshi's understanding of the function of the Control Contract's order size and the position limit is clearly not oriented to retail investors.

> "Contracts must be purchased in multiples of 5,000 contracts per order. This order size is an appropriate amount for large institutions to mitigate risk and is consistent with other futures and derivatives products. The Exchange has further imposed position limits (defined as maximum loss exposure) as described in Appendix A."[10]

Position limits for "excluded commodities," such as event contracts, have only the function to limit the losses of a market participant according to Kalshi's Rulebook, likewise confidential in this application. Kalshi position limits do not have the normative

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[6] https://www.cftc.gov/sites/default/files/filings/ptc/23/06/ptc0612232834.pdf, p. 2.

[7] Ibid., p. 2.

[8] https://www.cftc.gov/sites/default/files/filings/ptc/23/07/ptc0718234302.pdf

[9] https://kalshi.com/learn/video/refer-friend

[10] Ibid., p. 2.

purposes of speculative positions limits for physically backed derivatives contracts.[11] However, the value of the position may be far larger than positions taken in physically backed derivatives contracts.

The position limit for the Control Contract for "Entities shall be $5,000,000 per [Kalshi Exchange] Member; and $10,000,000 for those with demonstrated established economic hedging need. The Position Limit for Eligible Contract Participants ("ECP") shall be $50,000,000 per Member; and $100,000,000 for those with demonstrated established economic hedging need."[12] Kalshi determines what is an "sufficiently established economic hedging need" "solely at Kalshi's discretion." In other words, Kalshi defined "Entities" and "Eligible Contract Participants" can bet on the party control of Congress, with Kalshi's confidential methodology to determine a market participant's "sufficiently established economic hedging need" that bears only superficial similarity to Kalshi's retail-oriented event contracts.

According to the CFTC "Glossary," a hedger is "A market participant who enters into positions in a futures or other derivatives market opposite to positions held in the cash market to minimize the risk of financial loss from an adverse price change; or who purchases or sells futures as a temporary substitute for a cash transaction that will occur later."[13] The Control Contract allows market participants to take long and short positions on the outcome of the party control of the U.S. Senate and House of Representatives and thus superficially resembles hedging.

However, the economic consequences of the results of a party's control of a chamber of Congress during a specific session of Congress are impossible to predict, so there is not a cash market price to hedge. A Kalshi defined Entity or ECP may also be a political donor who spends $5,000,000 and more to ensure that the donor's party of choice wins an election in anticipation that the party's control of the House and/or the Senate will benefit the donor's economic interests. But those anticipated economic benefits do not constitute a cash market price that can be hedged by betting on the Control Contract. The public has no access to the confidential documents of Kalshi's methodology for demonstrating if a market participant has a "sufficiently established economic hedging need" to take a position of up to $100 million in the Control Contract. If the Commission

[11] From the preamble to the 2020 position limit rule: "First, CEA section 4a(a)(3)(B) requires the Commission when establishing Federal position limits, to the maximum extent practicable, in its discretion, to: (i) Diminish, eliminate, or prevent excessive speculation; (ii) deter and prevent market manipulation, squeezes, and corners; (iii) ensure sufficient market liquidity for bona fide hedgers; and (iv) ensure that the price discovery function of the underlying market is not disrupted. Second, CEA section 4a(a)(2)(C) requires the Commission to strive to ensure that any limits imposed by the Commission will not cause price discovery in a commodity subject to Federal position limits to shift to trading in foreign markets." https://www.federalregister.gov/documents/2021/01/14/2020-25332/position-limits-for-derivatives, p. 3289.

[12] Ibid., p. 7-8.

[13] https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/CFTCGlossary/index.htm#H

were to approve the Control Contract, it would allow Kalshi to determine the economic hedging need of investors seeking to bet on the election cycle future of a major institution of U.S. democracy.

IATP urges the Commission to disapprove the Control Contract. The Commission is not required by law or regulation to approve the Control Contract. At least $8.9 billion was spent to influence the 2022 congressional election outcome.[14] Bets to predict future congressional election outcomes will partly be informed by how and when such money is spent. Leave betting on electoral horse races to bookies. The CFTC must not give its imprimatur to that betting by approving the Control Contract, notwithstanding its superficial resemblance to bona fide hedging.

IATP responds here to a few of the Commission's many thoughtful questions about the Control Contract and its relation to the Commodity Exchange Act, Core Principles and CFTC regulations.

2. *What role does the requirement that the contracts trade in multiples of 5000 and/or the position limits applicable to the contracts play in the analysis of whether the contracts involve, relate to, or reference gaming as described in Commission regulation 40.11(a)(1) and section 5c(c)(5)(C) of the Commodity Exchange Act? Are the position limits reasonably enforceable?*

As noted above, the requirement to trade in multiples of 5,000 is intended to attract large institutional investors. The contracts relate to gaming because futures positions taken do not hedge a position in a cash market for economic benefit that can be quantitatively anticipated from the result of the party control outcome. IATP cannot determine if the position limits are reasonably enforceable, because based on the documentation provided by Kalshi, there is no way to determine if the position limits of the "General Terms and Conditions" serve to help Kalshi calculate whether a market participant has a "sufficiently established economic hedging need" for the position taken.

3. *Should the Commission consider whether similar offerings are available in traditional gaming venues such as casinos or sports books and/or whether taking a position on elections or congressional control is defined as gaming under state or federal law?*

Whether a wager is offered in a traditional gaming venue that is similar to the Control Contract, in the sense that the wager presents a binary option, does not offer the Commission a CEA basis for approving the Kalshi proposal, sets no legal precedent for the Commission, and is irrelevant to the Commission's approval or disapproval of this Proposal. The Commission should consider whether Kalshi has provided documentation

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[14] Taylor Giorno, "'Mid-term spending spree': Cost of 2022 federal elections tops $8.9 billion, a new mid-term record," Open Secrets, February 7, 2023. https://www.opensecrets.org/news/2023/02/midterms-spending-spree-cost-of-2022-federal-elections-tops-8-9-billion-a-new-midterm-record/

that allows the Commission to determine if the Control Contract enables the bone fide hedging required of other derivatives trading.

8. *Do the contracts serve a hedging function? What standard should be used in reviewing the contracts' hedging function? Is it sufficient that a contract could theoretically be used for hedging, or should an exchange provide evidence of demonstrated need by likely hedgers in the market? How often must a contract be used for hedging or what percentage of market participants or open interest must represent hedging use in order for a contract to serve a hedging function?*

The election information that is the contract's underlying asset does not correspond to the deliverable supply of a physical commodity for which hedging serves to manage price risk in a well-functioning derivatives market. No commercial hedger would buy or sell a contract in which the underlying could change at the Designated Contract Market's (DCM) discretion during a trading session, as Kalshi claims the right to change the Source Agency of election information of the Control Contract: "Kalshi retains the authority to designate a new Source Agency and Underlying for that Contract and to change any associated Contract specifications after the first day of trading. That new Source Agency and Underlying would be objective and verifiable. Kalshi would announce any such decision on its website."[15] Since the Source Agency for the Control Contract is "congress.gov," a change in the Source Agency would presumably be a court ruling about one or more disputed elections that would affect the control of one or both chambers of Congress. In such a politically and jurisprudentially volatile situation, market participation in the Control Contract would be highly speculative, even if the market participant traded based on insider information.

A DCM that claims its contracts are designed to hedge price risks must be able to estimate empirically the price risks of the underlying asset that the contract is designed to hedge. A theoretical demonstration is insufficient. For example, if a market participant claims that the party control of one or both chambers of Congress present an economic hedging need, that need should be established by a publicly available methodology that applies to all market participants in a category of participants, e.g., Entities. The Kalshi Control Contract proposal offers the public no objective and verifiable basis for determining a hedging need. In the absence of a publicly available methodology to demonstrate the hedging need for a contract position, bets under the terms of the Control Contract are purely speculative.

11. *Should the Commission consider contract and position sizes, size of trade requirements, and/or an exchange's intended customer base to help assess whether a contract is likely to be used for hedging in at least some cases? Does the requirement that all contracts listed on Kalshi must be fully-collateralized affect this analysis? Does the requirement that these contracts trade in*

[15] https://www.cftc.gov/sites/default/files/filings/ptc/23/06/ptc0612232834.pdf, p. 3.

multiples of 5000 and/or the position limits applicable to the contracts affect the analysis of the hedging utility of the contracts?

The "General Terms and Conditions" of the Control Contract do not mention full collateralization. The full collateralization of positions in Kalshi's retail-oriented contracts, e.g., the above-mentioned Screen Actors Guild strike ending date, is characteristic of event contracts. With a position limit of $25,000 in SAG contract, smaller positions are readily collateralized in full. But how many "Entities" and "Eligible Contract Participants," however Kalshi defines them, can fully collateralize positions from a limit of $5 million up to $100 million? It is exceedingly difficult to imagine that such large positions would be taken with no margin collateral unless they were sure bets with an underlying of unimpeachable price forming election information that is neither binding nor part of "Terms and Conditions."

13. *Do the contracts serve a price-basing function? For example, could they form the basis of pricing a commercial transaction in a physical commodity, financial asset, or service?*

The economic consequences of one party's control of either or both chambers of Congress are too various and complex to serve as a price basing function. One party's control might result in favorable regulatory treatment, subsidies, contracts and other benefits for a particular industry or companies within an industry. But it is difficult to imagine under what circumstances one party control would result in a price basing function for commercial transactions of products or services offered by that industry.

14. *Are the contracts contrary to the public interest? Why or why not?*

The publicly available terms and conditions of the Control Contract are not similar to Kalshi's retail-oriented event contracts. The confidential methodology according to which Kalshi alone decides whether a market participant has a "sufficiently established economic hedging need" makes a for profit exchange the gatekeeper to betting on the party control of one or both chambers of a major institution of U.S. democracy. IATP cannot imagine why transactions in the Control Contract would not be contrary to the public interest, regardless of which positions a market participant took in the contract. The Commission must not delegate to this DCM or any DCM control over a contract whose underlying price forming election information is susceptible to disinformation campaigns both foreign and domestic, laws and polling administration to limit or deny voter access and/or court rulings that contribute to the dispute or even denial of election outcomes.

22. *Should the Commission be responsible for surveilling, and enforcing against, possible manipulative and/or false reporting activity involving the price forming information for the contracts, while the contracts are trading?*

Under the "General Terms and Conditions" of the Control Contract, price forming information, including "possible manipulative and/or false reporting activity," about the contract is not binding and not part of the contract: "All instructions on how to access the Underlying are non-binding and are provided for convenience only and are not part of the binding Terms and Conditions of the Contract."[16] Under such contract terms, once the Commission votes to approve the Control Contract, the Commission could not enforce the non-binding price forming information, even if possibly manipulative or falsely reported on the Kalshi website or elsewhere. The Commission's anti-fraud, anti-manipulation authority to investigate and take enforcement actions in the underlying likely would be difficult to apply to non-binding price forming information related to but not legally part of the Control Contract.

23. *Could trading in the markets for the contracts obligate the Commission to investigate or otherwise become involved in the electoral process or political fundraising? If so, is this an appropriate role for the Commission?*

The only situation in which the Commission might have to investigate the underlying of the Source Agency of the party control of one or both chambers of Congress would be if Kalshi chose a Source Agency whose objectivity and verifiability were in dispute. In such an extraordinary situation, it is likely that any such Commission investigation would be challenged in court by the major political parties and/or plaintiffs representing them.

[16] https://www.cftc.gov/sites/default/files/filings/ptc/23/06/ptc0612232834.pdf, p. 3.