February 3, 2012

Hon. Gary Gensler
Chairman
Commodity Futures Trading Commission
3 Lafayette Center
1155 21st Street NW
Washington, DC 20581

We are academic researchers who study prediction markets. We are writing in favor of allowing NADEX, or a similar entity, to offer a broad range of political and policy event futures, including the three they are currently proposing.

There are four broad reasons for our support:

1. Existing political event futures have proven useful. Political event futures have been offered in small quantities by the onshore Iowa Electronic Markets (IEM), and by offshore exchanges such as Intrade. Prices from these markets have made possible a broad range of academic research.[1]

2. Political event futures facilitate price discovery in other asset markets. One of the findings of this research is that firms and industries are exposed to political and policy risk.[2] Political event futures provide investors with a market-based assessment of outcome probabilities, which reduces investors' uncertainty when trading other assets.[3] In addition, if allowed to operate onshore, political event futures markets might eventually grow to the point where they provide useful hedging opportunities for firms. The currently proposed position limits are likely sufficient for most individuals to hedge their personal exposure to election outcomes.

3. The full potential of political event futures cannot be realized in academic-scale markets or offshore. Despite the utility of the IEM and Intrade, both markets are hampered by the current regulatory environment. An onshore exchange that allowed positions of the size NADEX is suggesting could ultimately reach a scale where it could attract liquidity to contracts that

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[1] For overviews of this research, see Forsythe, et. al. (1992), Berg, et. al. (2001), Wolfers and Zitzewitz (2004 and 2007), Arrow, et. al. (2008), and Snowberg, Wolfers, and Zitzewitz (2011).
[2] For examples, see Slemrod and Greimel (1999), Knight (2006), Snowberg, Wolfers, and Zitzewitz (2007a and 2007b), and Wolfers and Zitzewitz (2009).
[3] This beneficial effect is exemplified by Dittmar and Yuan (2008), who find that introducing sovereign bonds in emerging markets improves the liquidity of corporate bonds. Sovereign bond prices aggregate information about country risk, allowing investors in corporate bonds to focus on issuer-specific information.

currently do not succeed on Intrade. There are many exciting potential applications of such markets, in research and policy making. Offering contracts on questions of great popular interest (such as Presidential elections) is crucial to attracting investors to an exchange. Once there, they face lower costs of participating in other markets, such as those currently offered by NADEX.

4. Concerns about gambling and manipulation are misplaced. Trading securities whose payoffs depend on political outcomes is no more "gaming" than trading securities whose payoffs depend on commodity or equity prices. Clearly, one can trade any security out of gambling motives, so the key question is whether the subject of these contracts is a "game," or an economically important event. It is hard to argue that elections are not economically important events.[4]

   One might be concerned with two forms of manipulation: outcome and price manipulation. Many individuals have already large stakes in election outcomes; for example, top executives in a public company will have significant exposure via their equity holdings, as well as through any impact of the election on policies such as tax rates. Many individuals also have substantial exposure to election outcomes via their careers. Given the position limits proposed by NADEX, the market is likely to make at most a small contribution towards the number of individuals with meaningful stakes in election outcomes. One might be concerned with trading by those involved in supervising elections, and it might be reasonable for policy to prohibit trading by those individuals.

   Turning to price manipulation, there have been a couple episodes that appeared to be attempts by traders to influence perceptions of an election by manipulating prediction market prices. The evidence suggests that effects on prices are relatively short-lived, and effects on perceptions are often counter-productive for the manipulator (e.g., through media stories mentioning the manipulation).[5] Onshore election markets will likely be significantly more liquid, making price manipulation even less attractive. A further protection comes from the fact that the outcomes of interest (election winners) will be linked to prediction market prices only through perceptions.[6] Concerns about price manipulation might apply more to cash-settled futures, where contracts settle based on other financial market prices.

To summarize, we view markets in securities contingent on economically relevant events as an innovation that generates positive externalities (by aggregating information) as well as benefits to participants. Innovations with positive externalities should be encouraged by policy makers, not

[4] See, for example, the research cited in footnote 2.
[5] See, for example, Strumpf and Rhode (2008). As predicted by Hanson and Oprea (2009), price manipulation appears to attract entry by traders who trade against it.
[6] See Oprea, et. al. (2007) for an experiment which suggests that manipulating perceptions formed based on prices is more difficult than manipulating prices.

limited. If the Commission has questions about any of the statements made or research mentioned in this letter, it should feel free to contact any of the undersigned.

Signed,

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PS. Disclosure: None of the undersigned have paid consulting relationships with or investments in NADEX, except Prof. Hanson, who is indicated with a asterisk.

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