

June 26, 2023

Secretary of the Commission

Office of the Secretariat

U.S. Commodity Futures Trading Commission Three Lafayette Centre

1155 21st Street, N.W. Washington, D.C. 20581

Dear Chairman and Commissioners of the Commodity Futures Trading Commission:

## **Introduction:**

We are undergraduate researchers at Duke University focused on financial regulation whose areas of study include economics, mathematics, and computer science. In this letter, we hope to convince the Commission that they should not grant Kalshi approval to offer contracts related to partisan control of Congress. First and foremost, approving such contracts would contradict the Commission's prior treatment of similar contracts with respect to the North American Derivatives Exchange (Nadex) and PredictIt without suitable justification.

Additionally, we believe that such contracts pose a net societal harm despite their alleged benefits. Kalshi and its supporters contend that such contracts would function as useful hedging instruments, yield more accurate election predictions through aggregating public opinion, and serve a price-basing role for real assets. On the other hand, critics of said contracts have argued their existence could expose retail traders to needless financial risk and, more importantly, create the risk of market manipulation that could weaken both election integrity and the perception of election integrity. In analyzing these potential costs and benefits, we hope to illustrate why rejecting Kalshi's proposal to offer such contracts, and more generally, why preventing any exchange from offering event contracts related to election results in the future, is consistent with the prior rulings of the Commission, in accordance with state and federal law, and clearly in the

public interest. In summary, while the alleged benefits of such contracts are spurious and marginal, the risks are both legitimate and significant.

## **Background:**

Launched in 2021, Kalshi is a federally regulated exchange that offers binary “event contracts.”<sup>1</sup> These contracts allow users to purchase “yes” or “no” positions with regard to outcomes of particular events related to topics like the economy, climate, and public health.<sup>2</sup> Some of the exchange’s most popular recent contracts have concerned inflation data and the federal funds rate.<sup>3</sup> In July 2022, Kalshi submitted a proposal to the Commission asking to list a set of contracts that would allow users to predict which political party would be in control of the Senate and House following the 2022 midterm elections.<sup>4</sup> In the past, the Commission has been selective in permitting similar platforms to list political event contracts in acknowledgement of the potential risks inherent in allowing Americans to wager on election results.

In the early 1990s, the Commission provided Iowa Election Markets no-action relief to offer political event contracts under certain conditions.<sup>5</sup> Iowa Election Markets had to remain strictly a not-for-profit, academic organization that sought to research “whether markets can aggregate information and predict outcomes more accurately than alternative technology such as

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<sup>1</sup> Y-Combinator, “Kalshi: 1st Federally Regulated Exchange Where People Can Trade on Events,” <https://www.ycombinator.com/companies/kalshi>.

<sup>2</sup> Alexander Osipovich, “Online-Trading Platform Will Let Investors Bet on Yes-or-No Questions,” *WSJ*, February 17, 2021, <https://www.wsj.com/articles/online-trading-platform-will-let-investors-bet-on-yes-or-no-questions-11613557800>.

<sup>3</sup> Ibid.

<sup>4</sup> Eliezer Mishory to the CFTC Secretary of the Commission, July 19, 2022, <https://www.cftc.gov/sites/default/files/filings/ptc/22/08/ptc082422kexdcm001.pdf>.

<sup>5</sup> Andrea M. Corcoran to George R. Neumann, June 18, 1993, <https://www.cftc.gov/sites/default/files/files/foia/repfoia/foirf0503b004.pdf>.

public opinion polling.”<sup>6</sup> Additionally, the Commission prohibited any individual user from wagering more than \$500 and did not render an opinion on whether Iowa Election Markets violated any state laws.<sup>7</sup> In late 2011, Nadex, a binary options exchange, submitted a proposal to the Commission seeking to offer political event contracts for the 2012 elections analogous to those Kalshi seeks to list for the 2022 midterms.<sup>8</sup> The Commission rejected Nadex’s proposal, citing Section 5c of the Commodity Exchange Act (CEA) and two Commission Regulation clauses.<sup>9</sup> Specifically, the agency explained that numerous state statutes consider trading political event contracts to be a form of gambling and that the Nadex contracts failed the economic purpose test in that they could not be employed as a hedging tool due to the “unpredictability of specific economic consequences of an election” and provided “no price basing utility” for real assets.<sup>10</sup>

In 2014, the Commission offered no-action relief to a platform called PredictIt, a joint-venture between Victoria University in New Zealand and American for-profit political technology company Aristotle.<sup>11</sup> Like Iowa Election Markets, PredictIt also vowed that the platform would be used primarily for academic research purposes and that its operators would receive no compensation.<sup>12</sup> Unlike Iowa Election Markets, the Commission allowed PredictIt to

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<sup>6</sup> Andrea M. Corcoran to George R. Neumann, June 18, 1993, <https://www.cftc.gov/sites/default/files/files/foia/repfoia/foirf0503b004.pdf>.

<sup>7</sup> Jeff Sommer, “Forecasting the Future of Election Prediction Markets,” *NYT*, November 4, 2022, <https://www.nytimes.com/2022/11/04/business/election-prediction-markets-midterms.html>.

<sup>8</sup> Timothy G. McDermott to David Stawick, December 19, 2011, <https://www.cftc.gov/sites/default/files/stellent/groups/public/@rulesandproducts/documents/ifdocs/rul121911nadex002.pdf>.

<sup>9</sup> Ben Protess, “Panel Rejects Proposal to Allow Election-Related Trading,” *NYT*, April 2, 2012, <https://archive.nytimes.com/dealbook.nytimes.com/2012/04/02/panel-rejects-proposal-to-allow-election-related-trading/>.

<sup>10</sup> David Stawick, “Order Prohibiting the Listing or Trading of Political Event Contracts,” April 2, 2012, <https://www.cftc.gov/sites/default/files/stellent/groups/public/@rulesandproducts/documents/ifdocs/nadexorder040212.pdf>.

<sup>11</sup> Sommer, *NYT*, <https://www.nytimes.com/2022/11/04/business/election-prediction-markets-midterms.html>.

<sup>12</sup> Vincent McGonagle to Neil Quigley, October 29, 2014, <https://www.cftc.gov/PressRoom/PressReleases/7047-14>.

offer a higher cap on maximum wagers, increase the number of investors allowed on the platform, and advertise in a limited capacity.<sup>13</sup> The Commission reasoned that these modifications from the Iowa Election Markets precedent would allow PredictIt to better serve its academic function yet still prevent these contracts from harming the public interest.<sup>14</sup> While Iowa Election Markets continues to operate under its no-action relief, the Commission revoked PredictIt's relief in August of 2022.<sup>15</sup> The Commission has not commented specifically on how PredictIt violated the terms of their no-action letter; however, they reserve the right to revoke relief at their discretion.<sup>16</sup>

The Commission also recently took regulatory action against Polymarket, a crypto-based exchange that offers political event contracts.<sup>17</sup> Polymarket offered “off-exchange” contracts, which means that they did not have designated contract market (DCM) status like Nadex or no-action relief like Iowa Election Markets and PredictIt. As a consequence, Polymarket was forced to pay a \$1.4 million fine.<sup>18</sup> Polymarket, however, continues to offer event contracts related to the midterm elections to international users.<sup>19</sup> InTrade, an Ireland-based trading exchange, tried to offer similar off-exchange contracts to American traders before the Commission sued them in 2012.<sup>20</sup> Even though for-profit exchanges have not been allowed to offer political event contracts

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<sup>13</sup> Ibid.

<sup>14</sup> Ibid.

<sup>15</sup> Vincent McGonagle to Margaret Hyland, August 4, 2022, <https://www.cftc.gov/PressRoom/PressReleases/8567-22>.

<sup>16</sup> Neal E. Kumar, Serge B. Agbre, and Alexandra K. Calabro, “CFTC Staff Pull Longstanding No-Action Relief for Event Market PredictIt,” Wilkie, Farr, & Gallagher LLP, August 15, 2022, <https://www.willkie.com/-/media/files/publications/2022/cftcstaffpulllongstandingnoactionreliefforeventmar.pdf>.

<sup>17</sup> CFTC, “Release Number 8478-22: CFTC Orders Event-Based Binary Options Markets Operator to Pay \$1.4 Million Penalty,” January 3, 2022, <https://www.cftc.gov/PressRoom/PressReleases/8478-22>.

<sup>18</sup> Ibid.

<sup>19</sup> Ryan Deffenbaugh, “Prediction markets are facing a key test,” *Protocol*, October 17, 2022, <https://www.protocol.com/newsletters/protocol-fintech/kalshi-cftc-election-markets>.

<sup>20</sup> CFTC, “Release Number 6423-12: CFTC Charges Ireland-based “Prediction Market” Proprietors Intrade and TEN with Violating the CFTC’s Off-Exchange Options Trading Ban and Filing False Forms with the CFTC,” November 26, 2012, <https://www.cftc.gov/PressRoom/PressReleases/6423-12>.

to American traders, established markets for betting on American elections exist in Europe—particularly in the United Kingdom and Ireland.<sup>21</sup>

Thus far, Kalshi has abided by all applicable regulations. They have registered as a DCM through the CFTC, partnered with a registered affiliate derivatives clearinghouse organization (DCO), and sought and received proper approval for all the contracts they currently list.<sup>22</sup> One point of note is that Kalshi’s DCO, LedgerX LLC, is a subsidiary of FTX US Derivatives.<sup>23</sup> In response to FTX’s primary business unit, FTX Trading Ltd., filing for bankruptcy, Kalshi reassured its customers in an open letter that their funds were safe.<sup>24</sup> LedgerX was only authorized to clear fully-collateralized futures, options on futures, and swaps, and Kalshi users are not permitted to trade on leverage; however, because there are still a great deal of unknowns regarding the FTX collapse, there is reason to be wary of Kalshi’s relationship with the firm.<sup>25</sup>

Regardless of LedgerX’s status, the Commission should reject Kalshi’s proposal, because it is not materially different from Nadex’s proposal, and because allowing such contracts would threaten the perception of the United States’ election integrity. The arguments Kalshi advances with regard to these contracts’ hedging utility, predictive power, and price-basing function are not only weak but contradictory and dwarf in comparison to the imperative duty of public institutions to do what they can to strengthen election integrity and the perception of election integrity at a time when trust in our democratic processes is concerningly fragile.

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<sup>21</sup> Divya Chowdhury and Aaron Saldanha, “Betting markets expect U.S. election result by Wednesday,” *Reuters*, November 2, 2020, <https://www.reuters.com/article/usa-election-gambling-gmf/betting-markets-expect-u-s-election-result-by-wednesday-idUSL4N2HO37M>.

<sup>22</sup> CFTC, “Release Number 8302-20: CFTC Designates KalshiEX LLC as a Contract Market,” November 4, 2020, <https://www.cftc.gov/PressRoom/PressReleases/8302-20>.

<sup>23</sup> Kalshi, “Kalshi and LedgerX advance to next step of launching new event contracts exchange,” September 8, 2020, <https://kalshi.com/blog/kalshi-ledger-partnership>.

<sup>24</sup> Kalshi, “Kalshi Customer Funds are Safeguarded in Segregated Accounts,” November 11, 2022, <https://kalshi.com/blog/kalshi-customers-are-safeguarded>.

<sup>25</sup> LedgerX, “Overview,” <https://ledgerx.com/clearing>.

## **Analysis:**

### **Hedging:**

In examining the costs and benefits of allowing Kalshi users to trade binary options predicting the parties that would control the House and Senate following the midterms, we concluded that, while the benefits are tenuous and only accrue to a limited number of citizens, the potential risks are severe and could impact American society at large. According to the Commodity Exchange Act, the Commission is called to put proposed contracts to an economic purpose test to determine whether their existence would provide any hedging or price-basing utility.<sup>26</sup> Specifically, the Commission raises the question (6) of whether or not the economic consequences of a party controlling Congress are predictable enough to allow these contracts to serve a useful hedging function.<sup>27</sup> In rejecting Nadex's proposal in 2012, the Commission reasoned that there was too tenuous a connection between election results and specific economic consequences that could be hedged against.<sup>28</sup> In this sense, we see no good reason to believe that the Commission's argument here was flawed or that the relationship between election results and economic effects has changed.

For example, if a restaurant wanted to hedge against an expected change in the small business tax code that a particular party has indicated they would enact, Kalshi's contract would not offer as direct and robust a hedge as would, for instance, a bet against the price of beef increasing. In the latter case, the restaurant can definitively protect themselves against increases

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<sup>26</sup> Commodity Exchange Act, 7 U.S.C. § 1, United States Code, <https://www.law.cornell.edu/uscode/text/7/chapter-1>.

<sup>27</sup> CFTC, "Questions on the KalshiEX, LLC "Will <party> be in control of the <chamber of Congress>?" Contracts for Public Comment," <https://www.cftc.gov/sites/default/files/filings/documents/2022/orgkexppublicquestions220829.pdf>.

<sup>28</sup> Stawick, "Prohibiting Political Event Contracts," <https://www.cftc.gov/sites/default/files/stellent/groups/public/@rulesandproducts/documents/ifdocs/nadexorder040212.pdf>.

in the price of beef by purchasing cattle options that they can redeem if prices increase. In the former case, there are countless scenarios where the party that the restaurant bets on loses yet the tax change is still enacted. Perhaps, the winning party compromises with the losing party, allowing them to enact the tax change in exchange for concessions on what they deem to be a more important piece of legislation. In this example, the restaurant would have not only lost the bet on Kalshi's election contract, but it would also have been forced to pay the higher taxes. Depending on the magnitude of their hedge, the results could be disastrous for a small business. A more concrete example relates to student loans. In the 2020 election cycle, Democrats made it clear that they hoped to forgive student loan debt; however, even after President Biden used executive action to forgive \$10,000 of federal student loans per person, the constitutionality of his move is currently being challenged in the courts.<sup>29</sup> As such, a student who bet on President Trump winning the 2020 in order to hedge against their student loan debt not being forgiven would have lost the wager and also would have been forced to pay back their student loans. Accordingly, these examples illustrate that political events contracts are a poor hedging instrument and suggest that the flawed portrayal of political event contracts as adequate hedging tools could put retail investors at risk of financial harm.

In another submitted comment letter, NYU law professor Max Raskin argues in defense of these contracts as a useful means of hedging.<sup>30</sup> He is correct in stating that individuals often hedge against downside risks without being absolutely certain of the hedge's success.<sup>31</sup> However, the probability that an individual can account for all the nuances of the U.S.' political

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<sup>29</sup> Katie Lobosco, "What student loan borrowers need to know after a federal court struck down Biden's forgiveness program," *CNN*, <https://www.cnn.com/2022/11/10/politics/biden-student-loan-forgiveness-struck-down>.

<sup>30</sup> Max Raskin to the CFTC Secretary of the Commission, September 22, 2022, <https://comments.cftc.gov/PublicComments/CommentList.aspx?id=7311>.

<sup>31</sup> *Ibid.*

processes to predict that a piece of legislation will pass and to foresee the specific effect it will have on them given a party winning control of one house of Congress is nowhere near close to one hundred percent. While Professor Raskin believes that “congressional leaders make genuine attempts to enact the agendas they lobby for,” we are slightly less optimistic about the transparency and predictability of America's legislative processes and the willingness— let alone ability— of legislatures to enact their campaign promises.<sup>32</sup> By calculating a weighted-average from eleven academic studies, FiveThirtyEight estimates that presidents fail to keep roughly one-third of their campaign promises.<sup>33</sup>

### **Insurance:**

Kalshi claims that its exchange can be used as a form of insurance, but Kalshi is indisputably inferior to existing insurance in its ability to protect against future losses.<sup>34</sup> In an interview with Yahoo Finance, Tarek Mansour, a co-founder of Kalshi, claims that election betting and similar trades function as a transparently exchanged form of insurance.<sup>35</sup> More specifically, according to their website, Kalshi has advantages over traditional insurance due to its umbrella coverage, next day payouts, granular control, and lack of claims adjusters.<sup>36</sup> Though it is true that Kalshi allows investors to bet on specific events that may not otherwise be covered under insurance, such as election outcomes, these events are not direct indicators of loss or gain, and are therefore unreliable. Car insurance, for instance, can help cover the cost of a car crash in the event that it occurs; this form of insurance is directly contingent upon the presumed loss

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<sup>32</sup> Raskin, <https://comments.cftc.gov/PublicComments/CommentList.aspx?id=7311>.

<sup>33</sup> Timothy Hill, “Trust Us: Politicians Keep Most of Their Promises,” 538, April 21, 2016, <https://fivethirtyeight.com/features/trust-us-politicians-keep-most-of-their-promises/>.

<sup>34</sup> Yahoo Finance, *Yahoo Finance*, March 15, 2022.

<sup>35</sup> *Ibid.*

<sup>36</sup> “Hedge on Your Terms,” Kalshi, 2022, <https://kalshi.com/hedging>.



occurring. On the other hand, if a trucking business believes gas prices are tied to a particular congressional majority, they may try to protect themselves from the potential losses derived from gas price increases by betting on Democrats holding a congressional. While the policies politicians or political parties endorse may impact gas prices, no individual politician or party can unilaterally raise or lower gas prices. Rather than insuring one's business, one can only insure against a tangentially related factor, thus making this form of "insurance" far riskier than its traditional counterpart. Since Kalshi only hosts \$1 binary contracts, one can only truly bet on whether something will occur, but not on the extent of the occurrence. For example, one may bet that gas prices will increase, but they cannot bet on the amount by which they will increase, thus limiting Kalshi's ability to specifically insure against downside risks. Furthermore, while next day payouts may be advantageous, they may attract people who are in need of a payout quickly, thus making Kalshi more akin to gambling than an efficient insurance mechanism. In terms of granular control, which Kalshi describes as the ability to choose exactly how much money to bet and the option to cancel early to minimize losses, it is true that bettors may benefit from deciding how much to bet on a given event. However, this means bettors assume extra risk compared to insurance; while insurance rates are determined by underwriters using a number of variables, it is up to the individual to determine how much to invest in a given contract. Additionally, while bettors can cancel their orders before trades are made and close out their position by essentially buying contracts opposite to the direction of those that one wishes to cancel, it is not possible to cancel a trade. Therefore, Kalshi's cancellation ability is inferior to that of insurance policies, which can be canceled when one decides they do not want insurance anymore. Finally, the proposed benefit of not needing claims adjusters is not so much a benefit as it is a product of Kalshi not offering bets on getting into a car crash, for instance. Kalshi's insurance function is

more akin to speculation and gambling than it is to insurance against real-world risk. Overall, investors may have more flexibility through Kalshi than through traditional insurance, but they are not protected by insurance regulators or by the guarantee that they will be insured against the loss against which they are betting.

### **Price-Basing Utility:**

In response to another one of the Commission's questions (11), political event contracts fail to serve any real price-basing utility for the same reasons that they are an inadequate tool for hedging.<sup>37</sup> In the Commission's Nadex decision, they argued that "there is no situation in which the Political Event Contracts' prices could form the basis for the pricing of commercial transactions."<sup>38</sup> We see no reason to overturn the Commission's reasoning as the economic ramifications of an election are indirect and opaque – as discussed with regard to hedging – which implies that the price of election markets does not help determine the price of any physical or financial asset in a predictable manner. Some commenters have attempted to argue otherwise. The CIO of Sharp Square Capital, Filip Pidot, argues that decisions such as whether two companies should merge or not are affected by congressional majorities.<sup>39</sup><sup>40</sup> Here, Pidot makes a correct, yet weak, assertion that which party controls Congress will affect a corporate merger. A complex endeavor such as a corporate merger will obviously be impacted by which party controls Congress as they would presumably pass different laws and appoint different personnel

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<sup>37</sup> CFTC, "Questions on KalshiEX," <https://www.cftc.gov/sites/default/files/filings/documents/2022/orgkexppublicquestions220829.pdf>.

<sup>38</sup> Stawick, "Prohibiting Political Event Contracts," <https://www.cftc.gov/sites/default/files/stellent/groups/public/@rulesandproducts/documents/ifdocs/nadexorder040212.pdf>.

<sup>39</sup> Filip Pidot to the CFTC, September 2, 2022, <https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=69645&SearchText=>.

<sup>40</sup> Notably, Sharp Square Capital describes themselves as a "alternative investment management firm specializing in event futures on @kalshi."

to regulatory agencies that oversee mergers. However, the more pertinent question is what impact congressional control would have on the price of mergers. If a merger concerned a solar panel company, it is easy in hindsight to say that the Democrats 2020 congressional majority would increase its price because of the green tax credits that were ultimately included in the Inflation Reduction Act (IRA).<sup>41</sup> But, as shown through the example of student debt relief, not all campaign promises are kept. In this way, it is easy to say that a midterm election will affect the prices of companies, but it would be highly spurious to say that one can make meaningful inferences regarding the price of a company from the prices of election markets.

### **Gaming:**

In their rejection of Nadex's proposal, the Commission explained that "a federal statute defines the term 'bet or wager' as 'the staking or risking by any person of something of value upon the outcome of a contest of others.'"<sup>42</sup> The Commission specified that even though political event contracts on congressional majorities are only premised indirectly upon "the outcome of a contest between electoral candidates" they still defined the act of participating in Nadex's proposed markets as "betting" or "wagering."<sup>43</sup> In this way, Nadex's proposed markets would be considered gambling in several states where state statutes either define gambling in part as an act that involves "wagering" and "betting" or directly reference election wagering in their gambling definitions.<sup>44</sup> The only material difference between Nadex's proposal and Kalshi's is that Nadex

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<sup>41</sup> Francesca Paris, Alicia Parlapiono, Margot Sanger-Katz, and Eve Washington, "A Detailed Picture of What's in the Democrats' Climate and Health Bill," *NYT*, August 16, 2022, <https://www.nytimes.com/interactive/2022/08/13/upshot/whats-in-the-democrats-climate-health-bill.html>.

<sup>42</sup> Stawick, "Prohibiting Political Event Contracts," <https://www.cftc.gov/sites/default/files/stellent/groups/public/@rulesandproducts/documents/ifdocs/nadexorder040212.pdf>.

<sup>43</sup> *Ibid.*

<sup>44</sup> *Ibid.*

wanted to also list a contract relating to the Presidential election.<sup>45</sup> Thus, in response to the Commission's first question (1), we believe that Kalshi's proposed contracts do reference "gaming" as defined in Commission regulation 40.11 (a)(1) and 5c(c)(5)(C) of the Commodity Exchange Act.<sup>46</sup> Additionally, in response to the Commission's second (2) and third (3) questions, we believe that the Commission must consider whether taking a position on which party will win a congressional majority is illegal under state gambling laws.<sup>47</sup> Although Kalshi maintains that their platform is for trading and not gambling, political gambling is banned at the federal level.<sup>48</sup> In this way, we urge the Commission to consider what would distinguish trading on Kalshi's political event contracts from gambling.

### **Predictive Power:**

There is a long history of political betting in the United States, legal, or, in many cases, illegal. Before the rise of scientific polling, the political betting market functioned well as a predictor of elections at both the state and the national level.<sup>49</sup> Election betting consisted of standardized contracts that employed fixed dollar payments if a particular candidate won office; typically, so-called betting commissioners offered these contracts, held the stakes of both parties, and took a five percent commission on winnings.<sup>50</sup> In the 1880s, betting markets moved from poolrooms to the Curb Exchange and Broadway hotels, and in the 1920s and 1930s, specialist

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<sup>45</sup> Ibid.

<sup>46</sup> CFTC, "Questions on KalshiEX," <https://www.cftc.gov/sites/default/files/filings/documents/2022/orgkexpubliquestions220829.pdf>.

<sup>47</sup> Ibid.

<sup>48</sup> Rick Maese, "Political Betting Is Surging. The Forecast Is about to Get Complicated." *The Washington Post*, November 2, 2022, <https://www.washingtonpost.com/sports/2022/11/02/political-betting/>.

<sup>49</sup> Paul W Rhode and Koleman S Strumpf, "Historical Presidential Betting Markets," *Journal of Economic Perspectives* 18, no. 2 (2004): pp. 127-142, <https://doi.org/10.1257/0895330041371277>.

<sup>50</sup> Ibid.

firms comprised of betting commissioners emerged.<sup>51</sup> In the 1896, 1899, 1904, 1916, and 1924 elections, three newspapers, including the *New York Times*, provided almost-daily price quotations on different candidates' odds, and the average betting volume was over two hundred times the maximum amount wagered in any Iowa Election Market, with over \$165 million in 2002 dollars bet in the 1916 election.<sup>52</sup> However, after 1940, and concurrently with the rise of scientific polling – which was a substitute for betting odds free from the moral objections against gambling – and laws addressing moral hazard, election tampering, information withholding, and strategic manipulation, there was a significant reduction in betting activity.<sup>53</sup> Thus, while there is not much legal precedence for election betting, there is cultural precedence, and the data does suggest fair markets may work well as election indicators.

One of the main reasons Kalshi and its supporters believe political event contracts are beneficial is that they may serve as more accurate indicators of political outcomes than polling. Kalshi claims its markets host “the most accurate predictions in the industry.”<sup>54</sup> It is unclear if Kalshi is referring to the political betting industry – which, given the Commission’s history of eliminating participating parties, is a very small industry, at least domestically – or to the election prediction industry in general; in either case, Kalshi does not provide any evidence to support this claim. Writing in support of Kalshi, Dr. Jason Furman, the Former Deputy Director of the National Economic Council, claims that political betting markets provide important information regarding political outcomes.<sup>55</sup> Specifically, he argues that the White House,

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<sup>51</sup> Ibid.

<sup>52</sup> Ibid.

<sup>53</sup> Ibid.

<sup>54</sup> “Forecasting,” Kalshi, 2022, <https://kalshi.com/forecasting>.

<sup>55</sup> Jason Furman to the CFTC Secretary of the Commission, September 18, 2022, <https://comments.cftc.gov/PublicComments/ViewComment.aspx?ID=69708&GUID=264324ac-75cb-4c97-9d45-62baa1877335>.

economic researchers, and educators rely upon these markets in their work.<sup>56</sup> However, the assertion that political betting markets are accurate indicators of election outcomes relies upon the assumption that those engaged in the market are trading based on the outcomes they expect. In this way, Kalshi's argument that their political event contracts would serve as a hedging instrument contradicts their argument that their contracts would help predict election results. For instance, if someone thinks the Republicans will win the Senate, they may still bet on the Democrats winning to hedge against the perceived risk – in their opinion – that Democratic policies will increase their taxes, thus skewing the markets away from an accurate depiction of public opinion. Here, a trader using these political event contracts to hedge risk will bet not on the party they believe will win, but instead on the party they believe will expose them to some financial risk should they win. Even if only a fraction of Kalshi's users intend to use political event contracts to hedge, they would limit the ability of these contracts to provide accurate predictions. If Kalshi provided data concerning the breakdown of users and their primary goals with Kalshi, whether hedging or prediction outcomes, then it would be easier to analyze its efficacy as an election predictor. Accordingly, even though Kalshi's political event contracts are ineffective hedging instruments, the mere fact that Kalshi projects these contracts are effective hedging tools is good reason to believe that at least some traders will use them as such, thereby limiting the contracts' aggregated predictive power.

### **Market Manipulation:**

Kalshi's political event contracts could also be vulnerable to market manipulation that would impact their efficacy as predictors. As Better Markets argues in their comment letter,

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<sup>56</sup> Ibid.

parties privy to non-public information – such as campaign finance data and internal polling – may profit off of their knowledge.<sup>57</sup> Professor Rebecca Haw Allensworth notes in a 2009 Harvard Law Review article that, in 2004, an Ireland-based exchange called TradeSports offered an election market that experienced two “sustained attempts” of market manipulation.<sup>58</sup> In this regard, Better Markets argues that Kalshi has not offered – or at least disclosed to the public – any explanation for how they would combat such manipulation.<sup>59</sup> Allowing Kalshi to list these contracts without confirming that these markets would not be “readily subject to manipulation” would violate the Commission’s Core Principle Three requirement.<sup>60</sup> For example, trading syndicates could artificially lower the price of contracts and buy shares to sell for a profit once prices rise, or they could purchase shares at an elevated price to lead others to believe a given candidate is more likely to win.<sup>61</sup>

In the long run, Kalshi hopes to rival exchanges like the New York Stock Exchange and CME Group.<sup>62</sup> While they currently have a downside limit for \$25,000 for individual contracts, Kalshi plans on increasing this limit.<sup>63</sup> As it stands now, this \$25,000 limit already exceeds the \$850 investment limit the Commission set for PredictIt in their 2014 no action letter.<sup>64</sup> Further increasing their limit would help Kalshi attract institutional investors – something executives

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<sup>57</sup> Better Markets to the CFTC Secretary of the Commission, September 25, 2022, [https://bettermarkets.org/wp-content/uploads/2022/09/Better\\_Markets\\_Comment\\_Letter\\_KalshiEX.pdf](https://bettermarkets.org/wp-content/uploads/2022/09/Better_Markets_Comment_Letter_KalshiEX.pdf).

<sup>58</sup> Rebecca Haw Allensworth, “Prediction Markets and Law: A Skeptical Account,” 122 HARV. L. REV. 1217 (2009).

<sup>59</sup> Better Markets to the CFTC, [https://bettermarkets.org/wp-content/uploads/2022/09/Better\\_Markets\\_Comment\\_Letter\\_KalshiEX.pdf](https://bettermarkets.org/wp-content/uploads/2022/09/Better_Markets_Comment_Letter_KalshiEX.pdf).

<sup>60</sup> *Ibid.*

<sup>61</sup> *Ibid.*

<sup>62</sup> Ryan Deffenbaugh, “Election Markets Are Far from a Sure Bet,” *Protocol*, October 6, 2022.

<sup>63</sup> Jesse Pound, “This New Exchange Lets Investors Vote Yes or No on Major Events to Hedge Their Portfolios,” *CNBC*, December 29, 2021, <https://www.cnbc.com/2021/12/29/this-new-exchange-lets-investors-vote-yes-or-no-on-major-events-to-hedge-their-portfolios.html>.

<sup>64</sup> CFTC Director of the Division of Market Oversight Vincent McGonagle to Neil Quigley of the Victoria University of Wellington, October 29, 2014, <https://www.cftc.gov/PressRoom/PressReleases/7047-14>.

have also touted as a goal.<sup>65</sup> That being said, such increases would only make it easier for wealthy traders or syndicates to manipulate election markets. The vulnerability of these political event contract markets to manipulation not only detracts from the legitimacy of them as predictors of election outcomes, but it also opens elections themselves up to potential manipulation.

### **Election Integrity:**

In the United States, voter turnout is approximately sixty percent in presidential elections and forty percent in midterm elections.<sup>66</sup> In a recent ABC/Ipsos poll, only twenty percent of the public reported feeling “very confident” about the election system,<sup>67</sup> and fifty-six percent of Americans reported having little or no confidence that American elections represent the will of the people.<sup>68</sup> Following the January 6th attack on the United States Capitol and the perpetuation of President Trump’s election lies, bolstering rather than weakening our elections should be of paramount importance. If Americans believe that Kalshi’s election markets are accurate predictors of election outcomes – as Kalshi contends – these markets could affect voter turnout. Dr. Leonardo Bursztyn, a University of Chicago economist, identified “a causal effect of anticipated election closeness on voter turnout in Swiss referenda” across cantons where polling estimates differed.<sup>69</sup> In his paper, Bursztyn demonstrates that cantons where polling indicated

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<sup>65</sup> Segal, “MIT Grads Were Interns at Goldman and Citadel,” <https://www.institutionalinvestor.com/article/b1t43r4w6x4z3x/These-MIT-Grads-Were-Interns-at-Goldman-and-Citadel-Now-They-Want-to-Democratize-Hedging>.

<sup>66</sup> “Voter Turnout.” FairVote, October 17, 2022. <https://fairvote.org/resources/voter-turnout/>.

<sup>67</sup> Brittany Shepherd, “Americans' Faith in Election Integrity Drops: POLL,” *ABC News*, January 6, 2022, <https://abcnews.go.com/Politics/americans-faith-election-integrity-drops-poll/story?id=82069876>.

<sup>68</sup> Jennifer Agiesta, “CNN Poll: A Growing Number of People Lack Confidence in American Elections,” *CNN*, February 11, 2022, <https://www.cnn.com/2022/02/10/politics/cnn-poll-democracy/index.html>.

<sup>69</sup> Leonardo Bursztyn, Davide Cantoni, Patricia Funk, and Noam Yuchtman, “Polls, the Press, the Political Participation: The Effects of Anticipated Election Closeness on Voter Turnout,” July 2018, [https://faculty.haas.berkeley.edu/yuchtman/Noam\\_Yuchtman\\_files/close\\_polls.pdf](https://faculty.haas.berkeley.edu/yuchtman/Noam_Yuchtman_files/close_polls.pdf), 1.



close outcomes experienced greater voter turnout than cantons where polling indicated landslide outcomes, all else equal.<sup>70</sup> Although the research on this relationship is limited because economists have struggled to find suitable natural experiments, Bursztyn extrapolates that anticipated election closeness could have played a role in the 2016 U.S. Presidential election.<sup>71</sup> Here, he explains that conservative leaning sources, which he argues Republicans are more likely to see, predicted much closer election outcomes than non-partisan and left leaning sources, which could have incentivized Republican voter turnout.<sup>72</sup> In this sense, foreign adversaries could work to manipulate Kalshi's election markets by overwhelming them with a huge influx of trades to distort the public's expectation of election closeness and potentially negatively affect voter turnout. Even if one believes that foreign adversaries or any other mal-intentioned domestic groups will not attempt to manipulate Kalshi's elections markets and that perceived election closeness has no real causal impact on voter turnout, the existence of such risks could harm the perception of election integrity.

### **The Perception of Election Integrity:**

While some might feel that protecting the perception of election integrity is a subordinate concern beneath protecting election integrity, the 2020 Presidential election and its subsequent controversy demonstrated that protecting the perception of election integrity is just as important as protecting election integrity with regard to defending our democracy. Further, although we have explained why we believe Kalshi's election markets would not provide accurate predictors of election outcomes as the company believes, the effect Kalshi's markets have on voter

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<sup>70</sup> Ibid, 5.

<sup>71</sup> Ibid, 22.

<sup>72</sup> Ibid, 22.

behavior depends on how the public perceives their predictive accuracy. For example, if President Trump had been predicted to win the 2020 election based on the manipulation or inaccuracy of Kalshi's market, he and his supporters could have used this fact as evidence to support their fraudulent claims of election corruption.

Thus, in response to the Commission's twelfth question (12), we believe these contracts would harm the public interest through the impact they could have on the perception of election integrity. Trust in civil institutions represents the bedrock of democracy and sound public governance. The foundation of a healthy democracy has historically been rooted in trust, yet today, two-thirds of Americans have little to no confidence in the federal government.<sup>73</sup> Many ascribe this fading trust to a political culture and media landscape riddled with misinformation, and Kalshi's election markets would provide those who wish to sow division in this country yet another means to potentially manipulate the public perception surrounding election integrity. Accordingly, we urge the Commission to consider how election lies have poisoned our public discourse as a glaring demonstration of the impact that perceived flaws in election integrity can have on our country. Allowing Kalshi to list these contracts will hinder efforts to rebuild trust in our elections and increase the likelihood that election misinformation will have an impact on the public's acceptance of the 2024 presidential election results.

## **Conclusion:**

To reiterate, we strongly believe the best approach for the Commission to take is to ban Kalshi from offering event contracts that would permit trading on whether Democrats or Republicans will take control over each chamber of Congress after the midterm elections. These

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<sup>73</sup> Rosenberg, Stacy. "Trust and Distrust in America." Pew Research Center - U.S. Politics & Policy. Pew Research Center, July 27, 2021. <https://www.pewresearch.org/politics/2019/07/22/trust-and-distrust-in-america/>.

contracts are flawed hedging tools because of the unpredictable relationship between election results and subsequent economic consequences. With regard to these contracts' price-basing function, there is no good reason to question the Commission's verdict in 2014 that they serve no such function. Further analysis of the Nadex decision reveals that Kalshi's proposed contracts do in fact reference "gaming," and thus, may be considered gambling, in which case they would be illegal in several states.<sup>74</sup> Although there is some evidence supporting the predictive power of political markets, Kalshi's emphasis on hedging and their failure to explain how they plan to prevent market manipulation undermine their claim that their markets would have meaningful predictive power. The potential positive causal relationship between the anticipated closeness of elections and voter turnout increases the importance of addressing the market manipulation risks and demonstrates how manipulating political markets could influence election integrity. Even if actual market manipulation did not occur, the mere potential for such manipulation to occur weakens the perception of election integrity. Accordingly, the recency of the January 6th insurrection should serve as a stern reminder that if the public – or a part of the public – perceives elections to be corrupt, political violence can ensue. Rather than democratizing finance, as Kalshi hopes, these political event contracts may instead finance threats to democracy. The marginal benefit of allowing an election market that may produce better predictions cannot justify these outsized risks to the public interest, and specifically, to our democracy – at a time when bolstering trust in our civil institutions must be of the utmost importance. Thus, we urge the Commission to deny Kalshi's proposal to list contracts related to partisan control of Congress and to remain steadfast in their commitment to not allowing for-profit companies to create political trading markets.

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<sup>74</sup> CFTC, "Questions on the KalshiEX," <https://www.cftc.gov/sites/default/files/filings/documents/2022/orgkexpublicquestions220829.pdf>.

Sincerely,

Laura Boyle, Thomas Colicchio, and Morgan Joseph

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