<u>Comment Letter Regarding Proposed Rule 89 FR 4896</u>

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington DC 20581

Dear Mr. Kirkpatrick,

Subject: Comment Letter Re Proposed Rule 89 FR 4896 Advocating for Event Futures Contracts as Bona Fide Risk Transfer Mechanisms

The Commodity Futures Trading Commission (CFTC) is proposing amendments to further specify types of event contracts that fall within the scope of section 5c(c)(5)(C) of the Commodity Exchange Act (CEA) and are contrary to the public interest, such that they may not be listed for trading or accepted for clearing on or through a CFTC-registered entity. As a lawyer in the futures and derivatives space, and before this, a floor trader and broker, I am writing to advocate for the recognition and inclusion of futures events contracts as legitimate tools for risk transfer, particularly in the context of systemic risks and catastrophic events.

Modern portfolio diversification strategies, while effective against market volatility, fall short in addressing systemic risks that result from catastrophic events. As such, futures markets present a valuable opportunity to hedge against these risks much as interest rate contracts and financial market index contracts are already risk benchmarks vital to the global financial markets.

Argument for Bona Fide Risk Transfer

Systemic risks, by their nature, affect large portions of the market simultaneously, rendering traditional diversification strategies ineffective. Catastrophic events, including climate-related disasters, can have widespread financial impacts that transcend individual market segments. Futures contracts tailored to these risks provide entities with a mechanism to hedge against potential losses, thus enhancing financial stability.

The introduction of futures contracts focused on political events and even climate and other catastrophic risks would contribute to overall market stability by allowing for risk transfer. By providing a structured way for businesses and governments to manage risk, these contracts can mitigate the financial disruptions caused by unforeseen catastrophic events. This stability is essential for maintaining investor confidence and ensuring the smooth functioning of financial markets.

Futures markets are instrumental in generating forward-looking price signals that reflect collective market expectations. Contracts based on catastrophic events can provide valuable information on perceived risks and potential impacts, aiding in better risk assessment and planning. These signals can drive investments in mitigation and adaptation strategies, contributing to broader societal resilience against systemic risks.

The evolution of financial markets has always been driven by innovation. The development and adoption of futures contracts for systemic risks represent a natural progression in the financial sector's ability to manage complex risks. These instruments can attract new participants, enhance liquidity, and promote a deeper understanding of risk dynamics.

The CFTC's mandate includes promoting market integrity and protecting market participants. Enabling futures contracts for catastrophic risks aligns with these goals by providing robust risk management tools that protect against significant financial disruptions. Moreover, these contracts can support public policy initiatives aimed at enhancing economic resilience and sustainability.

Modern Portfolio Theory (MPT) primarily addresses unsystematic risk through diversification but does not adequately account for systemic risks. Historical events such as the 2008 financial crisis and recent climate-related disasters have highlighted the limitations of MPT in shielding portfolios from systemic shocks. Futures contracts for systemic risks offer a complementary risk management tool, enabling investors to hedge against large-scale disruptions that traditional diversification cannot mitigate.

Comparison with Election Event Contracts

On December 11, 1992, the Chicago Board of Trade (CBOT) introduced catastrophic insurance futures contracts, they were designed to transfer risks associated with catastrophic events, providing a valuable hedging tool for the insurance industry. The foresight of the exchange was remarkable. Arguably we may be seeing what happens when the insurance industry cannot adequately transfer risk and the costs are passed to the consumer public. While there may arguably be valid public policy reasons to exclude election event contracts, it is important to recognize that they share similarities with catastrophic events in terms of the systemic risks they pose to the market. Allowing futures contracts for such events would provide a structured risk transfer mechanism, benefiting market stability and offering protection against significant financial disruptions.

The concept of bona fide risk transfer mechanisms, as established in existing futures markets, extends beyond traditional definitions of the gaming industry. The futures market has already proven effective in managing the largest types of risks that affect the global financial markets, including those arising from systemic and catastrophic events. For example, during the crash of 1987, market participants were able to short the equity market through the use of futures. By considering the inclusion of election contracts within this framework, the Commission can enhance the market's ability to manage a broader range of risks. This approach aligns with the overarching goal of providing robust risk management tools to market participants.

Game Theory Argument

From a game theory perspective, the inclusion of futures contracts for catastrophic events can create a more resilient market structure. In an environment where market participants can hedge against systemic risks, the overall market becomes more robust and less susceptible to panic and systemic failures. This strategic interaction benefits all participants by distributing risk more effectively, reducing the likelihood of extreme outcomes that can destabilize the entire financial system. Moreover, by allowing hedging against large-scale risks, futures markets can encourage proactive risk management and investment in mitigation strategies, fostering a more stable economic environment.

In game theory, the concept of Nash equilibrium can be applied to understand how futures markets for catastrophic events can stabilize the financial system. Suppose each market participant i has a set of strategies $S_{i,}$ which include hedging through futures contracts. The utility function U_i (S_i, S_i) represents the participant's payoff, where $S_{\_i}$ denotes the strategies of all other participants. In a Nash equilibrium, each participant's strategy is optimal, given the strategies of others:

$$Ui(Si*, S-i*) \geq Ui(Si, S-i*) \forall Si \in Si*, \forall i$$

By hedging through futures contracts, participants mitigate their exposure to catastrophic risks, leading to a stable equilibrium where no participant can improve their utility by unilaterally changing their strategy. This equilibrium reduces the overall risk in the system, contributing to market stability.

Conclusion

In conclusion, recognizing and incorporating futures contracts as bona fide risk transfer mechanisms for systemic risks and catastrophic events aligns with the fundamental purposes of futures markets. If the regulated futures markets are able to hedge the risk of the entire economy through interest rates and the domestic capital markets through financial futures, it can serve as a hedge against election risk.

I applaud the work of the CFTC in its work of keeping the United States futures markets among if not the most transparent and liquid financial markets in the world. The Commission would be well advised to see how election and other event contracts can play a crucial role in enhancing market stability, providing valuable risk signals, and supporting innovation in risk management. It is up to the task. I urge the CFTC to consider these arguments and facilitate the development of event futures contracts, thereby strengthening the financial market's ability to manage systemic risks effectively.

Thank you for considering my comments.

Respectfully,

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