

What's In The Cards For CFTC's Election Betting Case

By **Michelle Tanney, Kevin Edgar and Isabelle Sterling** (September 27, 2024)

On Sept. 12, the U.S. District Court for the District of Columbia ruled that the U.S. Commodity Futures Trading Commission exceeded its statutory authority in preventing KalshiEx LLC, a regulated exchange and prediction market startup, from offering derivatives contracts that take positions and trade on the outcome of the 2024 U.S. congressional elections.

Immediately after the decision, Kalshi launched its election betting contracts, only to be halted by the CFTC's immediate appeal to the circuit court. Oral argument on that appeal was held on Sept. 19.

While the legal status of these contracts remains unclear, the district court's decision marks a watershed moment in the permissibility of election betting, which has long been debated as critics sound the alarm on the potential for election manipulation.

Event Contracts and CFTC Authority

Kalshi is a CFTC-registered exchange that allows cash bets to be placed on a variety of real-world events. Specifically, through what it calls "event contracts," Kalshi allows users to buy positions on whether an event will or will not occur. These contracts are binary: If the stated event occurs, the holder of the "yes" contract profits while the holder of the "no" contract pays. The same holds true in the reverse.

Kalshi's platform allows users to purchase contracts that concern economics, the weather, science, and traditional financial instruments such as indices and commodities.[1] Trading is effectuated on Kalshi's exchange and occurs solely between its members.

In 2020, the CFTC, which regulates the U.S. derivatives markets, authorized Kalshi to list event contracts for public trading as a designated contract market, which allows exchange traders to engage in swaps, futures and options transactions.

The CFTC regulates Kalshi, and other exchanges under its jurisdiction, pursuant to the Commodity Exchange Act, or CEA, which has a special rule governing the review and approval of event contracts. This rule, which was added to the CEA in 2010, states that the CFTC has the authority to determine whether an event contract listed on a designated contract market or swap exchange facility is "contrary to the public interest" if such contracts involve (1) unlawful activity under federal or state law; (2) terrorism; (3) assassination; (4) war; (5) gaming; or (6) other similar activity determined by the CFTC, by rule or regulation, to be contrary to the public interest.

Any such contract determined by the CFTC to be contrary to the public interest pursuant to this provision is prohibited from being listed or made available for clearing or trading through a CFTC-registered entity.



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Pursuant to this authority, in September 2023, the CFTC issued an order disapproving of congressional control political event contracts self-certified by Kalshi.[2] These event contracts sought to allow traders to enter into a cash-settled binary contract asking, "Will [chamber of Congress] be controlled by [party] for [term]?"[3]

The CFTC determined that these contracts involved gaming and were thus unlawful under state law, contrary to the public interest, and, therefore, in violation of Section 5c(c)(5)(C) of the CEA as well as CFTC Regulation 40.11, which similarly prohibits a CFTC-registered entity from listing for trading a contract that involves, among other things, gaming. Kalshi brought suit against the CFTC in November 2023 challenging its final order.

Six months later, in May of this year, the CFTC sought to further clarify its rules through an amendment in response to the increase in the number of event contracts listed on CFTC-regulated exchanges. Specifically, the commission proposed that CFTC Regulation 40.11 be amended to further specify the type of contracts that fall within the scope of CEA Section 5c(c)(5)(C).

For example, the proposed amendment defined "gaming" to include examples, such as, relevant here, a political contest.[4] The comment period on the proposed rule was extended to and closed on Aug. 8.[5]

Kalshi's Lawsuit

Kalshi's November 2023 complaint argued that the CFTC exceeded its authority in blocking Kalshi's contracts.[6] Namely, Kalshi alleged the CFTC (1) misapplies the CEA, (2) ignores the purpose of the special rule, (3) applies a narrow exception to "swallow the rule," and (4) engages in faulty and unsupported reasoning.[7]

First, Kalshi alleged that the CFTC's reasoning that it has the ability to ban event contracts when the act of trading would amount to a prohibited activity is a misapplication of the CEA because, for example, "[t]rading an event contract can never amount to terrorism, assassination, or warfare." [8]

Thus, according to Kalshi, the only way to interpret the CEA is to read the prohibition as relating to contracts that actually involve prohibited activities.[9] The CFTC was therefore wrong in issuing its order because the flawed reading of "involve" should not, in any sense, apply to the contracts at issue because, plainly speaking, elections are not games — rather, they are events with "real economic consequences." [10]

Kalshi also alleged that the CFTC's interpretation of the words "involve," "gaming" and "unlawful" results in narrow exceptions that ultimately swallow the rule.[11] In other words, hypothetically, the CFTC could ban any event contract it deems to be against the public interest. Such sweeping authority, however, is unlikely to comport with congressional intent.

Moreover, Kalshi argued, the CFTC's public interest analysis created heightened requirements that fundamentally — in Kalshi's view — "misunderstand how risk hedging works" and ultimately would result in the CFTC condemning most event contracts.[12]

Conversely, the CFTC argued that because the statute does not define "involve," the plain meaning controls, which is broad enough to cover "both contracts whose underlying is an enumerated activity, and contracts with a different connection to that activity." [13] Indeed,

the CFTC put forth that the plain meaning of "involve" has been observed by many courts to have "expansive connotations." [14]

As to the issue of whether the contracts are construed as involving gaming, the commission argued that the contracts at issue relate closely enough in that gaming is their "essential feature" and "what these transactions 'entail,'" thereby having the ability to "affect" state laws that prohibit betting on elections. [15]

While in her Sept. 12 opinion U.S. District Judge Jia Cobb detailed how the CFTC arrived at its determination that the contracts involved "gaming," she ultimately disagreed. Specifically, she noted that the contracts "involve elections, which are neither" an unlawful activity nor gaming. [16] She also sided with Kalshi's argument that the CFTC was not given the broad authority by Congress to conduct the public-interest analysis it engaged in here.

Within minutes of the judge's opinion, trading of the event contracts commenced on Kalshi's website. Kalshi's CEO, Tarek Mansour, also shared his enthusiasm and remarked, "Today marks the first trade made on regulated election markets in nearly a century." [17] The CFTC, however, quickly appealed, which halted all trading during the pendency of the appeal.

On Sept. 19, a three-judge panel of the U.S. Court of Appeals for the District of Columbia Circuit heard arguments on the CFTC's emergency appeal to stay the district court's order. For its part, the CFTC argued that the implications of election betting are "profound" because they concern market manipulation and election integrity.

When questioned on the precise contours of the CFTC's concerns, Rob Schwartz, the CFTC's general counsel, explained that if a market participant were to distort the market in favor of a candidate, the allocation of campaign resources — time, people, money — could shift in response to what is, perhaps, a false sense of reality created by an interested actor. [18] Schwartz also noted that election betting markets, as opposed to traditional futures markets, are susceptible to infiltration by unreliable sources of information such as fake polling data. [19]

On the issue of election integrity, the CFTC was peppered with questions from the panel on whether there is a basis for such arguments when the impetus to vote and for whom to cast that ballot are grounded in a myriad of reasons, all of which have nothing to do with election betting markets. And although the CFTC referenced the large number of comment letters it received to indicate a level of public concern about election integrity, the court's questions seemed to indicate it did not find these letters dispositive of "irreparable harm." [20]

Kalshi's argument, consequently, touched on the fact that the CFTC failed to put forth "nonspeculative" evidence of harm that would be caused by these event contracts. [21] To establish that no such harm would exist, Kalshi pointed to the long history of election betting in markets across the U.K., Australia, Canada and New Zealand as tangible, rather than hypothetical, examples of how these markets operate.

In regard to the CEA rule at issue, Kalshi argued that its election contracts were not games because, it suggested, a game does not result in economic consequences. The judges quickly dismissed that assertion. During a back-and-forth concerning whether the election contracts had "game" qualities, the judges suggested that people could use the election contracts as a betting device rather than a hedging tool.

Given the fast-approaching election, it is likely that the circuit court will consider the arguments and render a decision in short order.

The Future of Election Betting

Although the district court's opinion is remarkable in what it could portend for the future of election betting, the reality is that election betting has occurred behind the scenes in U.S. politics for years.

The activity is not without its critics, however; those in opposition fear that allowing gambling on elections could threaten U.S. democracy.

For example, Sen. Jeff Merkley, D-Ore., fears that election gambling is "a deeply corrupting combination of dark money and election bets." [22] And CFTC Chair Rostin Behnam noted earlier this year, "Contracts involving political events ultimately commoditize and degrade the integrity of the uniquely American experience of participating in the democratic electoral process."

Those who support the endeavor believe that these markets provide helpful insight into where the electorate stands. In a May 3, 2024, bipartisan letter to Behnam on the CFTC's proposed amendment, several members of Congress noted that "the CFTC should embrace the authority Congress has already given it to encourage regulated and safe market activity on event contracts so the United States can continue to be a leader in financial market innovation." [23]

To be sure, the CFTC's response to Kalshi is its first attempt at clamping down on election betting. Notably, the CFTC remains involved in a dispute with PredictIt, a New Zealand-based online prediction market that offers bets on political and financial events. PredictIt is owned by the Victoria University of Wellington, a not-for-profit university. [24]

The Kalshi decision also raises important questions about financial market innovation, the breadth of the CFTC's jurisdiction, and the congressional response to agency action. While there has not yet been a legislative response to the Kalshi decision, Congress continues to hold hearings and consider legislative proposals to promote innovation in financial markets.

For example, on Sept. 18, 2024, the House Subcommittee on Digital Assets, Financial Technology and Inclusion held a hearing titled "Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets," [25] which considered several legislative proposals, including H.R. 9633, the Securing Innovation in Financial Regulation Act from Rep. Frank Lucas, R-Okla.

This legislation from Lucas would amend both the Securities Exchange Act and the CEA to codify the already-existing U.S. Securities and Exchange Commission's Strategic Hub for Innovation and Financial Technology, which will continue to assist the SEC with its approach to technological advancements; examine the impact that fintech innovations have on capital markets, market participants and investors; and coordinate the SEC's response to emerging technologies in financial, regulatory and supervisory systems.

The draft also codifies and reestablishes LabCFTC within the CFTC, which will serve as an information source for the agency on fintech innovation. LabCFTC was established at the CFTC in 2017 but was integrated into the Office of Technology Innovation in October 2021.

Conclusion

Given that the district court noted that election betting already occurs on unregulated markets, the CFTC will need to implement regulations or guidance lest its authority continue to be challenged.

Indeed, such efforts are already underway, but the regulatory response has been outpaced by the explosive growth of these markets. Accordingly, the D.C. Circuit's decision will not only answer the legalities of these contracts, but provide a road map for the CFTC to create a regulatory and enforcement response for future and similar products.

Notably, even if the circuit court upholds the district court's decision, further clarity will be needed on the contours and scope of election betting contracts, because such a decision may not set those parameters, including what additional political contests may be considered fair game.

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[1] Kalshi website, About Kalshi, available at <https://kalshi.com/about>.

[2] Order Prohibiting Listing and Making Available for Clearing or Trading through Kalshi Congressional Control Contracts (CFTC, Sept. 22, 2023), <https://www.cftc.gov/sites/default/files/filings/documents/2023/orgkexkalshiorsig230922.pdf>.

[3] Id.

[4] Rostin Behnam, Chairman, CFTC, Statement Regarding Proposed Event Contracts Rulemaking (May 10, 2024), <https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement051024>.

[5] Extension of Comment Period for Proposed Amendments to Event Contracts Rules, 89 Fed. Reg. 55528 (June 27, 2024).

[6] Complaint at 3-4, KalshiEX LLC v. CFTC, No. 23-cv-3527 (D.D.C. 2024).

[7] Id. at 4.

[8] Id. at 3-4.

[9] Id. at 4.

[10] Id. at 4.

[11] Id. at 5.

[12] Id. at 5.

[13] Defendant CFTC's Cross Motion for Summary Judgment and Opposition to Plaintiff's Motion for Summary Judgment at 20, *KalshiEX LLC v. CFTC*, No. 23-cv-3527 (D.D.C. 2024) (emphasis in original).

[14] Id. at 21.

[15] Id. at 22.

[16] Memorandum Opinion Regarding Plaintiff's Motion for Summary Judgment and Defendant's Cross Motion for Summary Judgment at 2, *KalshiEX LLC v. CFTC*, No. 23-cv-3527 (Sept. 12, 2024).

[17] Declan Harty, Ready your bets: Election gambling is going mainstream in the US, *Politico*, (Sept. 12, 2024, 5:14 PM), <https://www.politico.com/news/2024/09/12/election-gambling-us-00178904>.

[18] U.S. Court of Appeals for the D.C. Circuit, YouTube, Case No. 24-5205, *KalshiEX LLC v. CFTC* (Sept. 19, 2024), available at <https://www.youtube.com/watch?v=jDoxLV8jqeM&t=126s>.

[19] Id.

[20] Id.

[21] Id.

[22] Harty, *supra* note 17.

[23] Reps. Dusty Johnson, et al., Comment Letter on Proposed Rule Regarding Event Contract Markets (May 3, 2024).

[24] *Clarke v. CFTC*, No. 22-51124 (July 21, 2023).

[25] "Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets," Hearing Before the H. Comm. on Fin. Serv., Subcommittee on Digital Assets, Financial Technology and Inclusion, 118th Cong. (2024), available at <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=409360>.