
Market Integrity and Manipulation in Election Prediction Markets

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[Note: Attorneys from WilmerHale will discuss these issues and others during our upcoming webinar “Previewing the CFTC’s Post-Election Agenda” on October 29, 2024. CLE credit is available—register [here](#).]

Until recently, the Commodity Futures Trading Commission (CFTC) has limited the ability of US persons to participate in election markets.¹ However, recent developments have allowed event contracts to be made available to US participants through registered designated contract markets (DCMs) and swap execution facilities (SEFs). In addition, prediction markets open to non-US persons have gained significant attention and trading volume.

These developments have led to concerns about the integrity of election prediction markets and their potential susceptibility to manipulation. This uneasiness has been heightened by reports that a large trader has had a potentially outsized impact on the price of an election contract on a certain venue.² However, many of these concerns conflate issues related to the efficiency of

¹ The CFTC’s Division of Market Oversight (DMO) issued staff no-action positions to two academic institutions that provided that, subject to specified terms, DMO will not recommend to the Commission enforcement action against the academic institutions for failure to comply with the DCM, SEF or foreign board of trade registration requirements if they operate small-scale, not-for-profit markets that offer trading in political and economic indicator event contracts for academic purposes. See CFTC Staff Letter No. 93-66 (Jun. 18, 1993); CFTC Staff Letter No. 14-130 (Oct. 31, 2014) (the “PredictIt No-Action Letter”). In September 2022, DMO rescinded the PredictIt No-Action Letter. Parties affiliated with PredictIt sued the CFTC in federal district court, and they moved for a preliminary injunction. When the district court failed to rule on the motion, the PredictIt parties appealed what they deemed the effective denial of a preliminary injunction. The Fifth Circuit ultimately reversed the effective denial and remanded with instructions that the district court enter a preliminary injunction pending its consideration of the PredictIt parties’ claims. *Clarke v. CFTC*, 74 F.4th 627 (5th Cir. 2023); see also Matthew B. Kulkin and Ayana Dow, CFTC, 5th Circuit Upend the Future of Prediction Markets, WilmerHale (Oct. 3, 2023), available at <https://www.wilmerhale.com/insights/client-alerts/20231003-hard-to-predict-cftc-5th-circuit-upend-the-future-of-prediction-markets>.

² See, e.g., Alexander Osipovich, *A Mystery \$30 Million Wave of Pro-Trump Bets Have Moved a Popular Prediction Market*, WALL ST. J. (Oct. 18, 2024), <https://www.wsj.com/finance/betting-election-pro-trump-ad74aa71>; Jennifer Sor, *3 Theories About the \$46 Million ‘Whale’ Moving Betting Odds in Favor of Donald Trump*, BUSINESS INSIDER (Oct. 23, 2024), available at <https://www.businessinsider.com/trump->

election markets, and the potential but difficult-to-quantify impact of these prediction markets on election integrity writ large, with the legal standard for manipulation.

As we set out below, positions established in election markets based on good faith beliefs about the outcome of the election are very unlikely to constitute market manipulation, even if they result in significant market impact. In this client alert, we begin with a high-level summary of the CFTC's treatment of election contracts under the Commodity Exchange Act (CEA) and its key anti-manipulation authorities. We then discuss why concerns about election market efficiency should generally not be conceptualized as manipulation.

I. Event Contracts and the Commodity Exchange Act

Event contracts are “generally understood to be a type of derivative contract, typically with a binary payoff structure, based on the outcome of an underlying occurrence or event.”³ In the typical scenario, the contract will carry a specified notional value—such as \$1—and define two potential outcomes, such as whether a particular candidate will or will not win an election. When the event materializes, the holder of the winning position will be paid the entire notional value of the contract. The relative pricing of the two binary outcomes is generally viewed as the market's estimation of the likelihood of the event occurring.⁴

Event contracts are treated as derivatives on excluded commodities and subject to the CFTC's jurisdiction. CFTC Regulation 40.11, which was adopted as part of the Commission's Dodd-Frank implementing regulations, prohibits event contracts that “involve[], relate[] to, or reference[] terrorism, assassination, war, gaming, or an activity that is unlawful under any State or Federal law.”⁵ Regulation 40.11 further provides that the CFTC may prohibit contracts that involve or are related to “an activity that is similar” to the presumptively illegal event contracts and that it deems are “contrary to the public interest.”⁶

The CFTC has taken the position that election contracts are “related” to gaming and therefore subject to a public interest review under Regulation 40.11.⁷ Under this interpretation, the

[election-odds-polymarket-bets-polls-kamala-harris-2024-10](https://www.cnn.com/2024/10/24/politics/election-odds-polymarket-bets-polls-kamala-harris-2024-10/); Kevin Breuninger, *Frend trader bet over \$28 million on Trump election win using 4 Polymarket accounts*, CNBC (Oct. 24, 2024), available at <https://www.cnn.com/2024/10/24/politics/election-odds-polymarket-bets-polls-kamala-harris-2024-10/>.

³ Event Contracts, 89 Fed. Reg. 48968 (Jun. 10, 2024).

⁴ The CFTC defines a binary option (such as an event contract) as “[a] type of option whose payoff is either a fixed amount or zero.” See “Futures Glossary,” Commodity Futures Trading Commission (accessed on Oct. 25, 2024), available at <https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/CFTCGlossary/index.htm>.

⁵ 17 C.F.R. § 40.11(a)(1).

⁶ 17 C.F.R. § 40.11(a)(2).

⁷ See *In the Matter of the Certification by KalshiEX LLC of Derivatives Contracts with Respect to Political Control of the United States Senate and United States House of Representatives* (Sept. 22, 2023), <https://www.cftc.gov/sites/default/files/filings/documents/2023/orgkexkalshiordersig230922.pdf>;

Commission largely prohibited the listing or trading of election contracts in the United States. However, just last month, the US District Court for the District of Columbia held that election contracts are not related to gaming and therefore are not subject to the CFTC's public interest review. While the CFTC has appealed this decision, registered contract markets are now permitted to make election contracts available for trading by US persons in ways that were previously prohibited.⁸

II. *Anti-Manipulation Framework*

Traditionally, to establish that a market participant engaged in market manipulation, the CFTC has been required to meet a four-part test. Specifically, the CFTC must establish (1) that the accused had the ability to influence market prices; (2) that the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand; (3) that artificial prices existed; and (4) that the accused caused the artificial prices.⁹ In cases of attempted manipulation, the CFTC may ignore the last two prongs. Today, this four-part test still applies under CEA Sections 6(c)(3) and 9(a)(2) and Regulation 180.2.¹⁰

Courts have held that this test requires proof that the defendant intended to create an artificial price. For example, in *CFTC v. Donald R. Wilson*, the CFTC alleged that a large proprietary trading firm engaged in market manipulation by placing orders during the settlement window for certain interest rate swaps, with the understanding that its trading activity would influence the settlement price to reflect the trading firm's view of the contract's value.¹¹ However, a federal judge in the Southern District of New York held that the activity was not manipulative. Even though the trading firm took action to influence the settlement price, there was no evidence that it intended to create an "artificial" price, because it had a bona fide interest in fulfilling every order it submitted, it was able to credibly explain its trading strategy and its orders were consistent with its valuation model.

Matthew B. Kulkin, Megan O'Flynn and Ayana Dow, Divided CFTC Releases 'Gaming' Event Contract Rule Proposal, WilmerHale (May 16, 2024), <https://www.wilmerhale.com/insights/client-alerts/20240516-divided-cftc-releases-gaming-event-contract-rule-proposal>.

⁸ See, e.g., "Interactive Brokers Introduces Forecast Contracts on Election Outcomes," Interactive Brokers (Oct. 3, 2024), <https://www.interactivebrokers.com/en/general/about/mediaRelations/10-4-24.php>; Laura Matthews, *US Appeals Court Clears Kalshi to Restart Elections Betting*, REUTERS (Oct. 2, 2024), <https://www.reuters.com/legal/us-federal-court-upholds-ruling-letting-kalshiex-list-election-betting-contracts-2024-10-02/>.

⁹ See, e.g., Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41407 (Jul. 14, 2011) ("Part 180 Adopting Release").

¹⁰ See *In re Ind. Farm Bureau Coop. Ass'n, Inc.*, CFTC No. 75-14 (Dec. 17, 1982); Part 180 Adopting Release, 76 Fed. Reg. at 41,407.

¹¹ Memorandum and Order, *CFTC v. Wilson & DRW Investments*, No. 13-cv-7884, 26 (S.D.N.Y. Nov. 30, 2018).

More recently, the CFTC adopted Regulation 180.1, which is modeled after Exchange Act Rule 10b-5, the Securities and Exchange Commission's general anti-fraud and anti-manipulation rule, and prohibits any "manipulative or deceptive device or contrivance."¹² This new rule expanded the CFTC's anti-fraud authority and reduced the CFTC's burden for establishing manipulation. To establish a claim under Regulation 180.1, the CFTC need not show that the defendant intended to create an artificial price. However, it still must establish that the defendant recklessly engaged in manipulative conduct.¹³

III. Considerations Specific to Election Prediction Markets

Given this legal framework, there are significant hurdles for characterizing many concerns about the integrity or efficiency of election markets as manipulation:

First, under the traditional test for market manipulation, to establish a claim for manipulation, the CFTC must show the trader had an intent to create an artificial price. If someone is sufficiently confident in a particular election outcome, the value of the contract to them may approach the contract's notional value (the amount received at expiration, e.g., the full \$1 contract price). Even if the trader's activity impacts the market price or direction of the contract, their purchases will drive the price toward the trader's honest view of the contract's actual value. Thus, absent evidence that someone specifically intended to influence a contract's price in a way that did not track that person's subjective views about the outcome of the election, it would be very difficult to establish that they acted with the necessary intent.

Second, while Regulation 180.1 does not explicitly require the CFTC to establish that a trader intended to create an artificial price, the CFTC would still be required to show that person acted recklessly and employed a manipulative device. It would be challenging to establish these elements against someone who simply acquired inventory in the open market in support of a bona fide belief about the outcome of the election without engaging in other fraudulent conduct. Indeed, much of the commentary regarding allegedly disruptive traders in the current political event contract markets notes that those traders have acquired inventory through small trades over time. While not dispositive, this could reflect an attempt to minimize market impact and would be evidence that the conduct was not reckless or manipulative.

Third, the CFTC would have stronger claims with respect to manipulation against individuals who engaged in coordinated wash trading to create artificial price or volume action.¹⁴ While pure manipulation claims—even under Regulation 180.1—would require proof that the person traded in a way that was intended to create an artificial price or recklessly employed a

¹² 17 C.F.R. § 180.1.

¹³ See, e.g., *In re Vitol Inc.*, CFTC No. 21-01 (Dec. 3, 2020).

¹⁴ 7 U.S.C. § 6c(a).

manipulative device, the bar for establishing wash trading is much lower and requires proof that a person engaged in trading with no economic risk and no net change in beneficial ownership to influence prices or trading volumes.¹⁵

Finally, there may be significant political and prudential pressures that discourage the CFTC from taking enforcement actions against participants in election markets, at least until well after the contract has settled. While commentators or regulators can question whether a particular event contract is accurately priced or whether a large trader's actions are rational, there remains a significant possibility that the trader is correct and will profit from their activity. Indeed, prediction markets are designed to incentivize persons with unique knowledge to participate in size to improve price discovery. Taking action to discourage such activity could reduce the efficiency and accuracy of the market.

¹⁵ See, e.g., *Wilson v. Commodity Futures Trading Comm'n*, 322 F.3d 555, 559 (8th Cir. 2003) (“Wash sales involve the use of techniques designed to give the appearance of submitting trades to the open market, while negating the risk or price competition incident to the market. Wash trading produces a virtual financial nullity because the resulting net financial position is near or equal to zero. Such transactions are considered harmful because they create illusory price movements in the market.”).

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