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## Prediction Markets: An Emerging Opportunity

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Prediction markets have rapidly moved into the mainstream of financial innovation. These markets are very flexible and allow users to take a position on the outcome of a wide array of events — from elections and sport events to the top artist on Spotify — and have gained significant traction with both institutional traders and retail customers.

With that attention has come litigation, including several pending court cases initiated by state gaming agencies to challenge the longstanding federal preemption enjoyed by the CFTC over the markets it regulates. These cases have the potential to shape the prediction market landscape for years to come. As major industry entrants have signaled long-term commitment to this space, and with regulatory leadership changes on the horizon, this is a critical moment in the development of prediction markets.

### What Are Prediction Markets?

Prediction markets are exchanges on which people trade event contracts. Event contracts are financial instruments that allow participants to take a position on the likelihood or outcome of future events, such as will the New England Patriots win the 2026 Super Bowl, or which party will win the U.S. House this year. They are typically structured like binary yes/no options: a contract can pay out a fixed amount (e.g., \$1) if an event occurs and \$0 if it does not.

Traders purchase or sell these contracts at prices that reflect the probability of the underlying event and can use event contracts to hedge against economic risk. For example, a property owner in Louisiana could purchase an event contract predicting that a hurricane in the Gulf will reach landfall in his state to offset the risk of damage caused by the storm.

Prediction markets are not new. Binary contracts have been trading on and off exchanges for decades. Other prediction markets have existed in academic or non-commercial forms. Most notable was the Iowa Electronic Markets, which the Commodity Futures Trading Commission (CFTC) has allowed to operate for decades pursuant to no-action relief based on its academic purpose (the no-action letter stated that the CFTC staff will not recommend the commission commence enforcement action for failure to comply with regulations).

But more recently, commercial platforms have started to offer a wider variety of event contracts for everything from sporting outcomes to the price of gas to a city's daily high temperature. The growing prevalence of prediction markets relating to sporting outcomes, first listed on a designated contract market by Crypto.com, has raised an interesting question: whether CFTC-regulated prediction markets, despite apparent federal preemption, may still trigger the application of state gaming or gambling laws?

## Regulatory History and Current Landscape

The CFTC is an independent federal agency charged under the Commodity Exchange Act (CEA) with regulating derivative markets. The CFTC has grappled for years with the status of prediction markets and the proper framework for regulating them. Under the CEA, only federally regulated exchanges (Designated Contract Markets, or DCMs) may offer event contracts to retail customers. 7 U.S.C. § 7a-2(c)(5)(C)(i).

After initially issuing several no-action letters to prediction markets based on their research and academic value, the CFTC began to take a more critical look, questioning whether certain event contracts should be permitted as unlawful or contrary to the public good. The CFTC turned its attention to election-related contracts, concerned that large-scale speculation on elections could result in market manipulation or election interference. Pursuant to its authority under the CEA, the CFTC initially rejected election-related contracts proposed by a prediction market as “gaming,” and “activity that is unlawful” and “contrary to the public interest.” 7 U.S.C. § 7a-2(c)(5)(C)(i).

In September 2024, a federal court overturned the CFTC’s decision to reject Kalshi-listed election-related event contracts. In the wake of that decision, several prediction markets moved to self-certify numerous event contracts based not only on elections but also sports and other events.

This year, the CFTC began to embrace the opportunities for innovation that prediction markets offer, with Acting Chairman Caroline Pham signaling a more tolerant approach in a press release this past February. According to Acting Chairman Pham, the “CFTC must break with its past hostility to innovation and take a forward-looking approach to the [future] possibilities of” prediction markets.

## Litigation Over Event Contracts

The rapid expansion of prediction markets into sports events has led to increased litigation initiated by state and tribal gaming regulators. The outcome of these cases remains unsettled, as interested parties argue over the application of federal, state and tribal gaming laws to CFTC-regulated sports event contracts.

***Courts are weighing whether the CEA’s preemptive shield precludes state and tribal gaming laws from regulating event contracts offered on CFTC-regulated markets.***

Several state and tribal gaming commissions have issued warnings to prediction markets arguing that their activities are subject to state and tribal regulation. Prediction markets in response have sued state regulators in Nevada, New Jersey and Maryland seeking to enjoin the state and tribal commissions principally on the grounds that federal preemption precludes them from imposing their regulations on CFTC registered exchanges.

Courts hearing these matters have split on the issue of preemption. Two federal courts agreed federal preemption precludes state and tribal gaming laws and issued preliminary injunction orders enjoining enforcement of state and local laws. There is some dispute over whether conflict or field preemption should apply. If Congress preempted the field, as both courts found, then there is no room for the states or the tribes to regulate event contracts. Importantly, both courts defined the field as event contracts traded on a CFTC registered DCM, which limits preemption to only DCMs. Both courts alternatively indicated that conflict preemption may apply as well. In conflict preemption, the field is not preempted but instead preemption is limited to those state and local laws that undermine and conflict with the purpose and functioning of the federal law. Conflict preemption thus would allow some state and tribal regulation (e.g., state fraud enforcement) while preempting others (e.g., state licensing of DCMs). New Jersey appealed to the Third Circuit, where the panel of judges indicated a preference during oral argument for conflict preemption and raised questions about defining the field that was preempted by the CEA.

Two other federal district court decisions, however, found no preemption based on very different grounds. According to a Maryland district court, Congress did not intend to “completely preclude any state gaming laws from being applied to DCMs,” because Congress “expressly authorized the Commission to disallow

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event contracts that ‘involve … activity that is unlawful under … State law,’” and that provision would be superfluous if Congress intended to preempt the field and prevent the application of State gaming laws. 7 USC § 7a-2(c)(5)(C)(i). The court found the ambiguity of the exclusive jurisdiction clause, which the court admitted “cuts both ways,” on balance counseled against granting a preliminary injunction. The decision is currently being appealed to the Fourth Circuit.

After agreeing that event contracts fell within the CEA’s preemptive shield, a Nevada federal district court reversed its prior decision and found that sports event contracts do not fall within the CFTC’s exclusive jurisdiction because they are not swaps. The court interpreted the text of the CEA definition of swap as drawing a distinction between an “occurrence” and an “event” that would take outcome-based event contracts outside the CEA’s preemptive scope. The court opined that “[a]n ordinary American interpreting the word ‘event’ would conclude that the Kentucky Derby is an event. But who wins the Kentucky Derby is an outcome of that event, not a separate event.” The court further opined in dicta that a broader definition of swap incorporating outcomes means “anything can be defined as an event” and provides “no limiting principle” that would help define what is and is not associated with a “potential financial, economic or commercial consequence.” The parties have announced their intention to appeal the decision to the Ninth Circuit.

#### ***Additional state and tribal litigation continue.***

In California and Massachusetts respectively, a tribal community and a state gaming commission sued prediction markets, seeking to enjoin them from operating without a license in their jurisdictions. It seems likely that additional litigation in other states will follow.

In California, the federal district court rejected arguments that the Indian Gaming Regulatory Act (IGRA) controlled and overrode the CEA, finding that the Unlawful Internet Gambling Enforcement Act (UIGEA) of 2006 — a later enacted, more specific statute than the IGRA — expressly addresses internet gaming accessible in locations where such gaming is unlawful, including Indian lands. The UIGEA exempts “any transaction conducted on or subject to the rules of a registered entity or exempt board of trade under the Commodity Exchange Act” or “any other transaction that is excluded or exempt from regulation under the Commodity Exchange Act.” Because the contracts at issue were offered on a DCM and its transactions were accessible via the registered entity’s internet site, “its internet contracts are not bets or wagers under the UIGEA” and therefore are not gaming prohibited by the IGRA. The court also rejected the tribes’ arguments that event contracts are unlawful under the CEA, finding that the CFTC — not the court — had primary jurisdiction to decide whether event contracts violate the CEA. The tribes have announced their intention to appeal this ruling.

In the Massachusetts lawsuit, the state argues that the prediction market is unlawfully offering sports wagering without a license in violation of state law. Attempts to remove the action to federal court were recently denied. In the wake of that lawsuit, a retail brokerage firm also filed a separate action seeking a preliminary injunction barring the Massachusetts Attorney General from enforcing state gaming laws against the sports event contracts it markets. The federal district court denied the broker’s preliminary injunction motion, reasoning that it was premature given that the state’s pending suit against the prediction market offering those contracts remains outstanding and undecided.

#### **Looking Ahead**

The prediction market space has drawn serious attention from major technology firms, financial institutions, national sports leagues and exchanges. Several CFTC registrants have invested heavily in the future of prediction markets. New players also continue to enter the market. And the NHL announced its partnership with two prediction markets.

At the same time, the CFTC is undergoing a leadership change. Michael Selig was sworn in as the new Chairman of the CFTC, after serving as chief counsel of the SEC Crypto Task Force. Industry participants are closely watching to see how the CFTC will react to these recent events with a new Chair and his team running the Commission.

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As the regulatory landscape continues to evolve and markets expand, prediction markets present a rapidly emerging and dynamic opportunity. Look to this space for more updates and analysis as the courts and the CFTC consider and deliberate on these novel issues.



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