HEARING TO REVIEW PROPOSALS TO ESTABLISH EXCHANGES TRADING "MOVIE FUTURES"

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

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HOUSE OF REPRESENTATIVES

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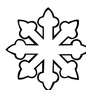

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HEARING TO REVIEW PROPOSALS TO ESTABLISH EXCHANGES TRADING "MOVIE FUTURES"

THURSDAY, APRIL 22, 2010

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:30 a.m., in Room 1300, Longworth House Office Building, Hon. Leonard L. Boswell [Chairman of the Subcommittee] presiding.

Members present: Representatives Boswell, Marshall, Walz, Schrader, Markey, Kissell, Pomeroy, Childers, Peterson (*ex officio*), Moran, Luetkemeyer, and Goodlatte.

Staff present: Aleta Botts, Clark Ogilvie, Rebekah Solem, John Konya, James Ryder, Debbie Smith, Kevin Kramp, Tamara Hinton, and Sangina Wright.

OPENING STATEMENT OF HON. LEONARD L. BOSWELL, A REPRESENTATIVE IN CONGRESS FROM IOWA

The CHAIRMAN. Our hearing will come to order. I would like to thank everyone for joining us here today as we take a thorough review of proposals to establish exchanges to trade movie futures. I would like to give a special thanks to our witnesses for testifying before the Committee and offering their insight.

The hearing today explores a novel, new product being considered for trading on a futures exchange regulated by the Commodity Futures Trading Commission. This product is movie futures or box office derivatives. When the Commodity Exchange Act was first passed in the 1930s, it was very unlikely that the Congress envisioned such a product would be regulated by the Act. Even with subsequent amendments to the CEA, I doubt those here today foresaw the development of this type of exchange. Nevertheless, two applicants have developed proposals to establish these box office exchanges and are seeking approval of contracts that would be offered there.

I am pleased that both applicants are here today to discuss the products in more detail and, hopefully, answer some of the concerns that have been raised about the nature of the marketing of these products. Mitigating financial risk is a primary reason for futures exchanges; however, the natural hedgers of the products have for the most part insisted they will not be using the products to

hedge their risk for various reasons. We look forward to hearing from our witness today on why this may or may not be the case.

The CFTC has approved the application to establish these exchanges, but the contract applications are still pending. This hearing is especially timely, given the current state of financial regulatory affairs and the actions going on in the Senate that we understand would establish in statute a prohibition of such exchanges. I hope the witnesses will provide this Committee with the context necessary to better understand these exchanges and the issues presented by them so that the Members here will be able to ascertain the correct course of action, going forward, and for future consideration of these applications by the CFTC and the law by the Congress.

Again, I would like to thank everyone for joining us today.

[The prepared statement of Mr. Boswell follows:]

PREPARED STATEMENT OF HON. LEONARD L. BOSWELL, A REPRESENTATIVE IN CONGRESS FROM IOWA

I would like to thank everyone for joining me here today as we take a thorough review of proposals to establish exchanges to trade "movie futures." I would like to give a special thanks to our witnesses for testifying before the Committee and offering their insight.

The hearing today explores a novel new product being considered for trading on a futures exchange regulated by the Commodity Futures Trading Commission. This product is movie futures, or box office derivatives. When the Commodity Exchange Act was first passed in the 1930s, it is very unlikely that the Congress envisioned such a product would be regulated by the Act. Even in subsequent amendments to the CEA, I doubt those of us here today foresaw the development of this type of exchange.

Nevertheless, two applicants have developed proposals to establish these box office exchanges and are seeking approval of contracts that would be offered there. I am pleased that both applicants are here today to discuss their products in more detail and hopefully answer some of the concerns that have been raised about the nature of the market for these products.

Mitigating financial risk is a primary reason for futures exchanges. However, the natural hedgers of these products have, for the most part, insisted that they will not be using the products to hedge their risks for various reasons. I look forward to hearing from our witnesses today on why this may, or may not, be the case.

The CFTC has approved the applications to establish these exchanges, but the contract applications are still pending. This hearing is especially timely given the current state of financial regulatory affairs and the action taken in the Senate yesterday that we understand would establish in statute a prohibition of such exchanges. I hope the witnesses will provide this Committee with the context necessary to better understand these exchanges and the issues presented by them, so that the Members here will be able to ascertain the correct course of action, going forward, and for future consideration of these applications by the CFTC and of the law by the Congress.

Again I would like to thank everyone for joining me today, and at this time I would like to turn it over to my good friend and colleague, Jerry Moran from Kansas, for any opening remarks he would like to make.

The CHAIRMAN. And at this time I will turn it over to my good friend and colleague, Jerry Moran of Kansas, for any remarks he would like to make.

OPENING STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM KANSAS

Mr. MORAN. Mr. Chairman, thank you. If somebody told me several months ago or a month ago we would have the Motion Picture Association of America and the Directors Guild in front of the Agriculture Committee, I would have thought they were kidding. But

here we are, and we are here to review a proposal to establish two box office future exchanges and the contracts to be traded on those exchanges. In fact, the exchanges are no longer proposals, because the CFTC has approved both the Cantor Exchange and the Media Derivatives Exchange within the last week.

It is my understanding that while the exchanges have been approved, the actual contracts are still pending Commission review and approval. Hopefully, Mr. Berkovitz will elaborate on the process. Up until 2 weeks ago I had never heard, and I am simply here to learn about a new exchange, the contracts those exchanges plan to trade, and the benefits and challenges that each may present.

The Commodity Exchange Act sets forth a set of standards an exchange must meet before it is approved by the Commission. I hope to learn how each exchange has met those standards and the analysis used by the Commission in reaching its decision. For instance, I hope the Commission and the witnesses explain the economic relevance of these exchanges and the potential contracts these exchanges will trade. I also want to know how these exchanges will prevent potential fraud and manipulation that might occur. In addition, there are some witnesses that have concerns about the contracts, and I want to gain a greater appreciation of those concerns.

I look forward to hearing the witnesses' testimony and hope to learn much more about this new concept of box office futures exchanges. Thank you, Mr. Chairman.

[The prepared statement of Mr. Moran follows:]

PREPARED STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM KANSAS

Thank you Mr. Chairman. If someone would have told me a month ago this Subcommittee would be holding a hearing where representatives of the Motion Picture Association of America and the Directors Guild of America were witnesses, I would have thought you were kidding. However, here we are reviewing a proposal to establish two box office futures exchanges and the contracts to be traded on those exchanges. In fact, the exchanges are no longer proposals because the Commodity Futures Trading Commission (CFTC) approved both the Cantor Exchange and the Media Derivatives Exchange within the last week. It is my understanding that while the exchanges were approved, the actual contracts are still pending Commission review and approval. Hopefully, Mr. Berkovitz will elaborate on that process.

Up until a few weeks ago, I had never heard of the concept of a box office futures exchange. I am simply here to learn about a new exchange, the contracts those exchanges plan to trade, and the benefits and challenges each may present.

The Commodity Exchange Act sets forth a set of standards an exchange must meet before it is approved by the Commission. I hope to learn how each exchange has met those standards and the analysis used by the Commission in reaching its decision. For instance, I hope the Commission and the witnesses explain the economic relevance of these exchanges and the potential contracts the exchanges will trade. I also want to know how these exchanges will prevent potential fraud and manipulation that might occur. In addition, there are some witnesses that have concerns about these contracts and I want to gain a better appreciation of those concerns.

I look forward to hearing from all the witnesses in today's hearing and hope to learn more about this new concept of a box office futures exchange.

The CHAIRMAN. Thank you, Mr. Moran. And I would like to recognize the full Committee chair, Mr. Peterson, who has joined us, for any remarks he might want to make at this time.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. PETERSON. I want to thank the gentleman. I just want to commend you and the Ranking Member for being on top of this issue. It sounds like there are going to be votes, so I won't take up any time and let you get on with the business. I look forward to hearing what the witnesses have to say.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Thank you, Chairman Boswell for holding this hearing today. While I am interested to hear what the witnesses today have to say both for and against this idea of establishing movie futures trading exchanges, I have to say that I have some significant questions about this idea, and I'm glad that we are having this hearing to learn more about the details involved.

Futures markets were created to trade contracts to buy specific quantities of a commodity or a financial instrument at a specific price at a specific time in the future. At a fundamental level, this is a risk management tool that offers benefits to both a buyer and seller of a given product. Now we're in a situation where people want to sell futures on movies the way they would sell a contract to purchase wheat. I understand that markets evolve, but this seems to be a stretch.

The question is whether this is a stretch too far. Returns on a box office are certainly different from bushels of wheat or barrels of oil. The CFTC has approved the applications to establish these exchanges based on their authorities in the Commodity Exchange Act. Given that it is hard to imagine these products being contemplated in the writing of that statute, I have to question what door to novel financial products this current example opens and exposes in the law.

I am interested in hearing more about the CFTC's decision making process and what they are considering as they make the determinations on these markets and products. I want to hear from the applicants for these futures contracts about what their rationale is for creating these exchanges, and I want to hear from the groups opposing this about why they are opposed to the idea and what they think will happen if these markets are approved.

There are a lot of questions about this out there, and I hope that we'll get some answers today. Thank you again, Chairman Boswell, and I look forward to the testimony.

The CHAIRMAN. Thank you. And I want to state to the other Members present, that their statements can be included in the record to get us right on to the task before us. We would recognize the first witness, and thank Mr. Berkovitz for being here. So, Mr. Berkovitz, please begin.

STATEMENT OF DAN M. BERKOVITZ, GENERAL COUNSEL, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. BERKOVITZ. Thank you, Mr. Chairman. Good morning, Chairman Boswell, Ranking Member Moran, Chairman Peterson, Members of the Subcommittee. Thank you for inviting the Commodity Futures Trading Commission to testify at this hearing on the possible trading of movie futures contracts. I would like to request that the Commission's full written testimony be included in the record.

The Commission's testimony addresses the standards and procedures with which an exchange must comply to be approved as a designated contract market, or DCM. This testimony will also describe the process for the Commission's review of the box office receipt futures contracts proposed to be listed for trading by the two

recently approved DCMs, Media Derivatives, and Cantor Futures Exchange.

An applicant for a DCM license must demonstrate to the Commission that it complies with the requirements of the Commodity Exchange Act and the Commission's regulations.

Specifically, the applicant must make a showing that it complies with the eight designation criteria and 18 core principles in the CEA. The Act generally requires that the Commission approve or deny a designation application within 180 days after it is filed. If the Commission denies the application, it must specify the grounds for the denial.

With regard to the approval of a product to be traded on the DCM, the CEA provides that a DCM may either self-certify new futures and options contracts, or voluntarily request approval of new products. To self-certify a new contract, the exchange must provide to the Commission, at a minimum, the rules that establish or relate to the contract's terms and conditions, along with a statement certifying that the contract complies with the Act and the Commission's regulations.

If an exchange requests Commission approval for a new contract, the CEA requires the Commission to approve or disapprove such product within 90 days. The CEA requires the Commission to approve such contract unless the Commission finds that the new contract would violate the CEA. It is the Commission's practice that all new contract filings are posted on the Commission's website, and public comment is requested. The primary focus on the Commission's review is to ensure that the contract is not readily susceptible to manipulation, and that the contract has speculative position limits or position accountability levels as appropriate.

The contract market designation process and the contract approval process are separate and distinct. The two processes involve different review procedures, time frames, and approval standards. Contract market applicants have the option to submit an application that does not include any proposed contract; however, in conjunction with the review of a new DCM application where the contract is not part of the application, the Commission staff typically inquires about the type of contract the applicant intends to offer for trading. Information about potential products to be traded helps inform the staff about the nature of surveillance and oversight measures that the exchange should have in place to be designated.

The Commission has recently approved contract market designation for two applicants that contemplate listing box office receipt contracts. The Commission designated Media Derivatives, Inc. on April 16 of this year, and Cantor Futures Exchange on April 20. Neither of these futures exchanges submitted their proposed futures contracts as a part of that DCM application. In both cases, the Commission carefully considered the applicants' submitted materials, representations made, and demonstrations related to the designation criteria and core principles. The Commission determined that the Media Derivatives and Cantor applications satisfied the requirements of the CEA and CFTC regulations, including the designation criteria and core principles. The order of designation for both Media Derivatives and Cantor requires them to submit to the Commission for review and approval any new class or category

of media-related products prior to listing them for trading. In doing so, the Commission preserved its ability to affirmatively review and approve these categories of futures contracts prior to their listing by the DCM.

Media Derivatives' and Cantor's proposed contracts are under active review. The Commission will carefully review these proposed contracts according to the time frame and standards under the CEA and the Commission's regulations. The focus of these reviews will be to determine whether the contracts are not readily susceptible to manipulation, whether there are appropriate position limits or accountability levels, and the integrity of the cash settlement process.

In summary, the Commission is committed to fulfilling its statutory responsibilities to oversee the futures markets. It has carefully reviewed the two recent DCM applications and determined that they met the statutory standards.

With respect to the contracts submitted for approval, the Commission, similarly, will conduct a thorough and careful review, seek and consider public comments, and make a decision based on whether the contracts under review meet the statutory criteria.

Thank you for this opportunity to testify. I look forward to any questions you may have.

[The prepared statement of Mr. Berkovitz follows:]

PREPARED STATEMENT OF DAN M. BERKOWITZ, GENERAL COUNSEL, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Chairman Boswell, Ranking Member Moran, and Members of the Subcommittee, thank you for inviting the Commodity Futures Trading Commission ("CFTC" or "Commission") to testify at this hearing to review proposals to establish exchanges trading "movie futures." The Commission appreciates this opportunity to present to the Subcommittee information about the standards and procedures used by the Commission, pursuant to the Commodity Exchange Act ("CEA"), to review applications for new exchanges seeking to trade futures contracts.

This testimony will address the standards and procedures that approved exchanges—called "designated contract markets" ("DCMs")—must follow in order to trade new futures contracts. In addition, this testimony will describe the Commission's activities with respect to the two applications recently approved for DCMs that intend to trade futures contracts whose settlement prices are based on the level of box office receipts from movie theaters ("movie futures" or "box office receipt futures"), as well as the status of the Commission's reviews of those proposed contracts.

The CFTC and its Mission

First, I would like to provide some background on the CFTC and its mission. The CFTC was established in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The CFTC assures the economic utility of the futures markets by encouraging their competitiveness and efficiency, protecting market participants against fraud, manipulation, and abusive trading practices, and ensuring the financial integrity of the clearing process. Through effective oversight, the CFTC enables the futures markets to serve the important economic function of providing a means for price discovery and offsetting price risk.

The CFTC currently oversees 16 DCMs and one exempt commercial market that lists a significant price discovery contract. The CFTC also oversees 14 clearinghouses, which reduce systemic risks by providing a guarantee of performance for all cleared trades. The CFTC oversees 66,187 registrants, which includes 51,921 salespersons, 1,277 commodity pool operators, 2,568 commodity trading advisors, 7,114 floor brokers, 1,447 floor traders, 166 futures commission merchants, and 1,694 introducing brokers. In 2009, 2,051 contracts were listed for trading on CFTC-regulated facilities, with a total trading volume of nearly 3 billion contracts.

There are several critical elements of the CFTC's oversight of futures and option trading. These include, among other things, regular surveillance of traders' positions and trading activity to detect and deter manipulation, market congestion, and abusive and unfair trading practices. Another fundamental component of market oversight involves the evaluation of the futures exchanges' capabilities and operations to ensure that they can fulfill the statutory requirements and their self-regulatory obligations. Such reviews are conducted initially for prospective DCM applicants and regularly thereafter through comprehensive staff evaluations of the exchanges' operations (called rule enforcement reviews).

Application Process for Contract Market Designation

An entity that seeks to establish an exchange for the trading of commodity futures, options and futures options must apply to the Commission to be designated as a contract market. In order to obtain Commission designation, an exchange must demonstrate to the Commission that it complies with the requirements of the CEA. Specifically, the applicant must make a showing that it meets eight designation criteria and complies with 18 core principles as specified in the CEA.

In general, to meet the requirements of the designation criteria and the core principles, the exchange applicant must demonstrate, among other things, that it has rules defining the manner in which it intends to operate and that it has rules, systems and structures to ensure the market and financial integrity of contracts to be traded on the exchange. For example, the designation criteria require an exchange to have systems in place to prevent market manipulation, to ensure fair and equitable trading, and to arrange for the clearing of transactions through a registered clearing organization. The core principles require an exchange to provide a competitive, open, and efficient market, only list for trading on the exchange contracts that are not readily susceptible to manipulation, establish and enforce position limits or accountability levels, and monitor trades for price distortion and disruptions of delivery or cash settled process. The core principles also address such issues as composition of boards, fitness standards for directors and members of the disciplinary committee, conflicts of interest in the decision-making process, and the emergency authority of the exchange and its management.

The CEA requires that the Commission approve or deny a designation application within 180 days of the filing of the application (Section 6(a) of the CEA, 7 U.S.C. § 8(a)). If the Commission denies the application, it must specify the grounds for the denial. Following a refusal to designate an applicant as a contract market, the Commission must provide the applicant with an opportunity for a hearing on the record before the Commission (Section 6(a), 7 U.S.C. § 8(a)). The applicant thereafter has a right to appeal an adverse decision directly to a Federal appeals court (5 U.S.C. § 706(2)).

The statute also contains a provision for staying the running of the 180 day time limit when an exchange is notified that the application for contract market designation is materially incomplete, and provides the Commission with at least sixty days for review once the application has been resubmitted in completed form.

CFTC Review of DCM Applications

The review of new exchange applications is a key element of the CFTC's oversight program. Such reviews are designed to ensure that the applicant has the ability to comply with all statutory and regulatory requirements. The review encompasses all aspects of the applicant's proposed operations, and it is comprehensive in its scope. Additionally, although not required by law, the CFTC's policy is to post all pending applications on its website, so that interested parties can comment on the merits of the filing.

The CFTC staff evaluates an applicant's ability to comply with the designation criteria and the core principles by conducting a thorough examination of the following elements of the proposed exchange:

- the rule book to ensure that the exchange has rules that promote transparent, fair and competitive markets, such as rules describing operation of the market, providing trading parameters and detailing the rights and obligations of participants in the market;
- clearing arrangements and settlement procedures;
- surveillance systems, staffing and capabilities, including the exchange's ability to obtain large trader and transaction data to identify unusual price changes and concentrated positions and to monitor position limit violations;
- the adoption of trade execution systems and procedures to ensure the integrity of trades, business continuity and data retention and to allow the exchange to carry out trade practice surveillance;

- disciplinary procedures that address rule violations and dispute resolution programs;
- procedures for having an open, competitive and transparent trading system to provide for the price discovery function of the centralized marketplace and to make available information to all traders on prices, volume and terms, through public dissemination of price and trade activity information as well contract terms;
- procedures and rules to minimize conflicts of interest, including composition requirements for the Board of Directors and the establishment of a regulatory oversight committee;
- procedures to take appropriate emergency action to protect traders and the market in cases where intervention is required; and
- the exchange's rules, trading protocols or policies to ensure that they do not result in any unreasonable restraints of trade or any anti-competitive burden on trading in the market.

Upon the conclusion of its review, the CFTC staff evaluates whether the applicant meets the requirements of the CEA, and recommends to the Commission whether to issue an order designating the exchange as a contract market. If the Commission finds that the applicant meets the requirements of the CEA and votes to designate, it issues an Order of Designation which may impose certain conditions involving financial, jurisdictional and regulatory compliance issues.

In conjunction with the review of a new DCM application, the CFTC staff typically inquires about the types of contracts to be traded on the exchange. Information about potential products to be traded helps inform the staff about the nature of the surveillance and oversight measures the exchange should have in place. The purpose of such information is to address, in a generic way, the exchange's ability to comply with designation criteria and core principles that address such issues as contract manipulation, general availability of information involving contract terms, mechanisms for executing trades, and recording and storage of trade information.

Notwithstanding the fact that the Commission may generally be cognizant during the course of the application review process of the possible contracts that an applicant plans to offer, under the CEA and the Commission's regulations, the contract market designation process and the contract approval process are separate and distinct processes subject to different review procedures, timeframes, and approval standards.[1] In contrast to the contract market approval process under the CEA prior to the passage of the Commodity Futures Modernization Act ("CFMA"), in which a prospective exchange had to include a contract as part of its application package, since the passage of the CFMA contract market applicants have the option to submit an application that does not include any proposed product.[2]

Contract Certification and Approval

The CEA provides that a DCM may either self-certify new futures and option contracts or voluntarily request approval of new products. To self-certify a new contract, the exchange must provide to the Commission, at a minimum, the rules that establish or relate to the contract's terms and conditions, along with a statement certifying that the contract complies with the Act and the Commission's regulations thereunder. A self-certification filing must be received by the Commission prior to the open of business on the business day prior to the intended initial listing day. Commission staff conducts a due-diligence review of the contract to verify the validity of the exchange's self-certification and, when necessary, may request amendments to the contract or additional information related to the contract or the underlying cash market.

With respect to products submitted for approval, the CEA specifies that the Commission must act to approve or disapprove within 90 days of the request for approval (Section 5c(c)(2)(C) of the CEA, 7 U.S.C. § 7a–2(c)(2)(C)). The Commission's

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[1] *See* section 5c of the Act, 7 U.S.C. § 7a–2(c), section 6(a) of the Act, 7 U.S.C. § 8(a), regulation 38.3, 17 CFR § 38.3, regulation 38.4, 17 CFR § 38.4, and regulation 40.3, 17 CFR § 40.3.

[2] Because the CEA, as amended by the CFMA, no longer requires that applicants include a proposed contract in their application to be designated as a DCM, staff's review of the application is limited regarding compliance with two contract-specific core principles; specifically, Core Principles 3 (Contracts Not Readily Subject to Manipulation) and 5 (Position Limits or Accountability). While the other core principles require DCMs to have structures, rules and procedures to address generic concerns, Core Principles 3 and 5 are contract-specific. Staff is, therefore, limited in its ability to assess compliance with those two core principles when a DCM application does not include a contract. Instead, the analysis of a DCM's compliance with Core Principles 3 and 5 is primarily carried out in the context of the contract review process.

regulations state that products submitted for approval may be deemed approved 45 days after the filing if the filing is complete and is not amended by the exchange, except for amendments made at the request of the Commission (17 CFR § 40.3(b)). The review period may be extended to 90 days if the product raises novel or complex issues that require additional time for review or is of major economic significance (17 CFR § 40.3(c)). All new contract filings are posted on the Commission's website, and the public is welcome to comment on those filings. The CEA provides, "The Commission shall approve any such new contract or instrument . . . unless the Commission finds that the new contract or instrument . . . would violate the Act." (Section 5c(c)(3) of the CEA, 7 U.S.C. § 7a–2(c)(3)).

The primary focus of the Commission staff's review of a contract approval request is to ensure that the contract is not readily susceptible to manipulation (Core Principle 3) and that the contract has speculative position limits or position accountability, as appropriate (Core Principle 5). If an exchange seeks approval of a contract, it must demonstrate that the terms and conditions as a whole will result in a deliverable supply such that the contract will not be conducive to price manipulation or distortion, in accordance with the Commission's Guideline No. 1 (17 CFR Part 40, Appendix A (2009)). For cash-settled contracts, such as the box office receipts contracts filed for approval by MDEX and Cantor, Guideline No. 1 specifies that the final cash settlement price must be not readily susceptible to manipulation, must be reflective of the underlying market, and must be reliable, acceptable for hedging, publicly available and timely.

MDEX and Cantor Applications for DCMs

The Commission has recently approved contract market designation for two applicants that contemplate listing box office receipt contracts. These exchanges are Media Derivatives Inc. and the Cantor Futures Exchange.

Media Derivatives Inc. ("MDEX") was formed in April 2007 to operate as an electronic futures exchange to trade contracts based on movie box office revenues and other unspecified entertainment industry contracts. It is a Delaware corporation and wholly-owned subsidiary of Veriana Networks, Inc., a privately-held media and technology company. MDEX submitted its application for contract market designation on September 25, 2009; the voluntary public comment period was open until November 5, 2009. That application was preceded by numerous draft materials submitted by MDEX to the Commission, as well as numerous supplemental materials submitted after the formal filing date.

Some notable features of the MDEX application: MDEX has contracted with the National Futures Association ("NFA") to provide it with regulatory services and has an agreement with the Minneapolis Grain Exchange to provide clearing services. In addition to its reliance on NFA, MDEX will conduct its own real-time surveillance and some general market compliance. MDEX will be an intermediated market and will utilize an electronic trading system with web-based access or direct connections. MDEX initially intends to trade Opening Weekend Motion Picture Revenue contracts in the form of binary options and collared futures. That contract review process is separate from its DCM application approval.

The Cantor Futures Exchange ("Cantor") was created to operate a non-intermediated electronic trading system to likewise trade, among other things, futures contracts on movie box office receipts. Cantor operates as a Delaware Limited Partnership and is a wholly-owned subsidiary of Cantor Fitzgerald, L.P., a global financial service firm. Cantor submitted its application to become a DCM on November 28, 2008; the voluntary public comment period was open until January 28, 2009.

The NFA will provide regulatory services to Cantor, including general market compliance and surveillance responsibilities. Like MDEX, Cantor will be responsible for certain aspects of its market surveillance and its market compliance. As proposed, clearing services will be provided by the Cantor Clearinghouse, which is also a wholly-owned subsidiary of Cantor Fitzgerald, L.P., and which submitted an application to become registered as a derivatives clearing organization contemporaneously with the Cantor DCM application. As a non-intermediated exchange, Cantor has undertaken certain functions that normally fall to intermediaries, such as filing certain reports with the Commission and providing trade confirmations and account statements to market participants.

As with the MDEX application, Commission staff was aware of Cantor's intention to initially list box office receipt contracts. Again, that contract review process is separate from its exchange application approval.

Staff's review of both the MDEX and Cantor applications addressed each of the regulatory requirements mentioned above.[3] The CFTC staff carefully considered the applicants' submitted materials, representations made, and demonstrations related to the eight designation criteria and 18 core principles, and in light of the expected novel products that they intend to list, put special emphasis on those designation criteria and core principles relating to the prevention of market manipulation and fair and equitable trading.

More specifically, staff considered whether MDEX and Cantor had the ability generally to detect and prevent market manipulation and trade practice violations, and also considered the extra steps MDEX and Cantor would need to take if they offered futures contracts based on box office revenue, such as the implementation of firewalls within a movie studio. In this regard, staff considered the sources of data for box office revenue figures, whether the information provided by these sources is reliable and verifiable, what extra tools MDEX and Cantor possess to track this information and analyze its reliability, and what extra market surveillance resources each exchange would be able to use to detect attempted manipulation or abusive trading practices.

Staff also considered the fact that NFA will be providing regulatory services for both applicants. NFA currently provides regulatory services to four other DCMs, and the Commission has previously found that NFA maintains acceptable surveillance and compliance practices in the context of other designated contract markets to which it provides regulatory services.

Staff concluded that the MDEX application satisfied the requirements of the designation criteria and core principles, and recommended Commission approval of the exchange. The Commission approved the designation of MDEX as a contract market on April 16, 2010.

Staff concluded that the Cantor application satisfied the requirements of the designation criteria and core principles, and recommended Commission approval of the exchange. Cantor was designated as a contract market on April 20, 2010.

The Orders of Designation for both MDEX and Cantor require them to submit to the Commission for review and approval any new class or category of media-related products prior to listing them for trading.

MDEX and Cantor Requests for Contract Approval

MDEX's and Cantor's proposed contracts are under active consideration for Commission approval as they were not part of the Commission's designation of MDEX and Cantor as DCMs. In conditioning these designations on the submission of the exchanges' initial contracts and all other new classes of media-related contracts for prior Commission approval, the Commission recognized that media contracts may require special review of other issues to ensure, among other things, that the contracts are consistent with the Act and the Commission's regulations and that the exchanges have appropriate surveillance and compliance measures in keeping with the unique nature of these contracts.

On March 9, MDEX requested approval of its collared futures and binary option contracts based on the Opening Weekend Motion Picture Revenues for the film *Takers*. The 45 day fast track review period would have ended on April 23, but the staff extended that review period by an additional 45 days so that it now expires at the end of the statutory review period (90 days after Commission receipt). That statutory review period ends June 7, 2010. MDEX has indicated that it also intends to list other media-related futures contracts.

On March 30, Cantor Exchange requested approval of its Domestic Box Office Receipts futures contract based on the film *The Expendables.* The Commission's 45 day review period for that contract ends May 14, but the Commission may extend that review period to June 28, 2010. Cantor has stated that it also intends to list other, non-media-related, more traditional futures contracts.

The Commission will specifically evaluate whether the MDEX and Cantor contracts are not readily susceptible to manipulation and whether the cash settlement provisions of each contract meet the Commission's Guideline No. 1 requirements, among other criteria. In addition, the Commission will consider other issues that have been raised as well as comments filed by interested parties related to those contracts.

[3] Except, as noted in note 2, *supra,* if the application does not include a contract, the Commission is limited in its review of the applicant's ability to comply with Core Principles 3 and 5 in the absence of a contract.

Conclusion

In summary, the Commission is committed to fulfilling its statutory responsibilities to oversee the futures markets in a timely, efficient, and thorough manner. The Commission has carefully reviewed the two recent DCM applications and determined that they met the statutory standards. With respect to the contracts submitted for approval, the Commission similarly will conduct a thorough and careful review, seek and consider public comments, and make a decision based on whether the contracts under review meet the statutory criteria.

Thank you, and I look forward to answering any questions.

The CHAIRMAN. Thank you. Before we continue, I would like to recognize Mr. Goodlatte from Virginia who has joined us. And although he is not a Member of the Subcommittee, he is here with us today, he is the former Chairman of the full Committee. And I have consulted with the Ranking Member, and we are pleased to welcome him to join us in questioning today. Welcome.

Mr. GOODLATTE. Thank you, Mr. Chairman. It is a pleasure to be here. I look forward to hearing the testimony of the witnesses regarding this very interesting subject.

The CHAIRMAN. Welcome.

The first question, I guess, would be: In reviewing the applications, did the CFTC examine the question of whether legitimate hedgers, both short and long, exist for these products? And, if so, what did the CFTC discover?

Mr. BERKOVITZ. As I have described, Mr. Chairman, the contract application and review process and the designation process for the exchange are two distinct processes. In the designation process for the exchange itself, in approving the exchange, we reviewed whether it met the designation criteria in the statute, including whether they have the trading facility, how the trades are executed, the financial integrity of the contracts, and the various systems in place to ensure fair and equitable trading.

Regarding the contracts, the questions that you have raised are more appropriately part of the contract approval process which we are in right now. So those questions are some of the questions that we are looking at in the contract approval process.

The CHAIRMAN. I appreciate that. Another question: Would you explain why the Commission approved the ability for people with material inside information to participate in these markets? All things being equal, would people with material inside information be allowed to participate in an SEC-regulated market?

Mr. BERKOVITZ. We have addressed that in a condition for the application. As I mentioned in the oral testimony, generally the exchange approval process and the contract approval process are different. In these particular instances we have looked at the request for approval of the exchange with a view towards what contracts will be included in the exchange. We have been in discussion with both applicants, so we have an idea. We did, in fact, know their intentions to list these movie futures contracts.

As part of that, to address the concern you have raised about people with inside information, potentially about the eventual box office numbers, trading in those futures contracts, we have included in the contract approval process the condition that these exchanges have what we call firewalls between the people inside the studios who would have actual knowledge of the box office receipts

from the people in those movie studios who might be trading for hedging purposes or whatever purposes for the studio.

We have included firewall conditions as part of the exchange approval process for both exchanges. Not only does it prohibit them from—people with that inside information about the actual box office receipts from trading, but it would prevent them from communicating information to others in the organization who might trade on that information. So those conditions have been included as part of the approval process for the exchange.

In addition, as part of the contract approval process, we are looking at that question further in terms of whether the contracts themselves are susceptible to manipulation. So the question is, in view of these particular contracts now and examining the concerns that have been raised by these contracts, we are looking at that issue with respect to these particular contracts: Are those firewalls sufficient? Have other concerns been raised that need to be addressed as part of the contract approval?

The CHAIRMAN. I will have further questions, but I will recognize Mr. Moran at this time.

Mr. MORAN. Thank you. Mr. Berkovitz, how does the CEA define a *commodity?* And how does the box office futures contract fit within that definition?

Mr. BERKOVITZ. The Commodity Exchange Act defines a *commodity* very broadly. It is basically anything, a good, an article, a service, or an interest in anything in which a contract for future delivery is dealt in. So if something is subject to a contract for future delivery, then under the Commodity Exchange Act, it would be a commodity.

Mr. MORAN. And the future delivery in this case is, what?

Mr. BERKOVITZ. The future delivery is the box office receipt. It is a number that is related to the actual box office receipts.

Mr. MORAN. My questions may be more related to the actual contracts. But what type of data do the exchanges use to settle those contracts?

Mr. BERKOVITZ. According to the information that has been supplied to us to date, and we are looking at this question in great detail, but they basically—they are going to be relying on the tally of box office receipts that are provided. There is a service that provides from the movie theaters to the studios what the actual box office receipt numbers are. That gets fed to the studios, and the studios—I believe, and they will be able to answer the questions—also collect some of this data and the studios put the data together, and then there is the final number from the receipts that they get plus their own information.

Mr. MORAN. When you say a final number, is that an actual hard number, or is that an estimate?

Mr. BERKOVITZ. I believe there is an actual firm number.

Mr. MORAN. Okay. How is the opening price of a contract determined? And are there currently any other exchanges that use that method?

Mr. BERKOVITZ. We can provide further information for the record on this. But, generally, my understanding of it is that it is similar to the process that other exchanges use for determining what the opening price of a contract is, that before the contract is

actually open for trading, that there is a type of bidding process that goes on that the exchanges use to establish where the contractors should start to be traded. But we can get you further information on exactly how that would be determined and any similarities or differences.

Mr. MORAN. Do you have an estimate of the time frame in which the CFTC would make a decision in regard to the actual contracts?

Mr. BERKOVITZ. There is a statutory deadline, I believe, it is June 7 for one of the contracts and June 28 for the other one.

Mr. MORAN. Mr. Chairman, thank you. And I yield back.

The CHAIRMAN. Thank you. The chair now recognizes Mr. Kissell from North Carolina.

Mr. KISSELL. Thank you, Mr. Chairman.

Mr. Berkovitz, I am trying to get an understanding, as the Ranking Member said, of knowledge of this subject matter, when the Commission is looking at a new product coming on to a market—and you mentioned about the factors that are considered as to whether this is a legitimate product or not. How judgmental does the Commission become in terms of one extreme, just strictly, "Okay, it meets the points, fine, let's do it." And the other extreme, "This just has no business being there, this just is not something we should be doing." How does that weigh in terms of, once again, is it just black and white there, or judgmental it shouldn't be there?

Mr. BERKOVITZ. Generally, our first look at it would be, is this something that is indeed a contract for future delivery? That's our jurisdictional base. So we will say, is this a contract for future delivery that is appropriate for further review?

If it is indeed a contract for future delivery, then we apply the standards set forth in the Act. Primarily, is it not susceptible to manipulation? Are there appropriate position limits? Is the settlement price of the contract appropriately determined? Is there the process for determining that price, is there integrity in that process?

Mr. KISSELL. What considerations might be given to unique circumstances that could affect a movie's popularity in terms of the investments that were made *versus* the insurance that might be used to offset unexpected things? What if we found out 3 days before the release that a star had been having illicit affairs? Or the snows came deep in February and affected the opening days; or there was some other crisis that kept people at home? Are we opening ourselves up to issues there that are beyond what we should normally expect? How does that play in?

Mr. BERKOVITZ. Well, our primary focus is on ensuring that there was no manipulation of the price of that commodity that is traded. So we would have our surveillance and the exchanges—we require of the exchange to have surveillance, too, to ensure that there is no artificial price created through any intentional manipulation of the price. And we watch the price move to ensure that indeed the price of these—or any contracts that are traded on any exchanges, are determined according to the laws of supply and demand, basically.

Mr. KISSELL. Thank you, Mr. Berkovitz. Mr. Chairman, I am looking forward to hearing more of the arguments from the individuals. I yield back.

The CHAIRMAN. Thank you. Mr. Goodlatte.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. Berkovitz, welcome. Can you think of any other commodity that is traded on the major exchanges that is anything like a motion picture?

Mr. BERKOVITZ. In a broad sense, the motion picture contract, one could describe it as an event type contract that is related to an economic event or an event. We have weather derivatives, we have——

Mr. GOODLATTE. But weather derivatives are beyond the control of any individual. Are they not?

Mr. BERKOVITZ. Certainly.

Mr. GOODLATTE. And the gentleman from North Carolina, he raised several different types of events. Some of those events were like a big snowstorm. That is beyond the control of anybody who is trying to predict. And that certainly would not be unlike buying corn futures, not knowing what the weather was going to be like or things like that.

On the other hand, the motion picture itself, each one of those that is produced is a very unique product, very much unlike the next one. Whereas, one barrel of oil is not very much different than the next one, one bushel of corn is not very much different than the next one, one Euro dollar is not very much different than the next one.

So it seems to me that in looking at the very broad definition of *commodities* that the CFTC has, nonetheless in looking at motion pictures you are going into an area that we have never done before, in my opinion.

Can you give me anything that is like that, that is of such subjective value as a motion picture that is offered on these exchanges?

Mr. BERKOVITZ. I think the issue that you raised in terms of control or ability to affect the price in terms of a weather derivative, nobody can affect the temperature in Chicago or Seattle. The question that has been raised about these contracts: Can somebody affect the box office receipts? In that sense, that distinction is indeed something we are looking at and seeing whether——

Mr. GOODLATTE. I have heard there is some discussion at the CFTC about actually excluding people who are involved in the making of a motion picture from being able to trade these futures contracts. Is that correct?

Mr. BERKOVITZ. The conditions that were imposed upon the exchanges themselves, the firewall that is between the people that actually have knowledge about the actual box office receipts, we are examining again whether those firewalls are sufficient for these particular contracts, because these concerns have been raised about who really has this type of knowledge.

Mr. GOODLATTE. But if you were to do that and to say that all of the producers and directors, actors and the crews, and the people involved in the promotion of the movie and so on were not allowed to participate because they have a better idea than the average

public about whether this movie is going to be an *Avatar* or whether it is going to be a bust. Correct? That would be a concern. But aren't those the same people that you ordinarily are wanting to have participating in commodity trading? Because they are the ones who benefit from one of the principle purposes of commodity trading, which is to take the risk out of what you are investing in.

Like a farmer being able to buy or sell corn futures because he wants to average out the future price, because weather or other market conditions might affect his price. Or somebody in manufacturing who is concerned about the price of natural gas or oil that they use as a resource for their business, they want to buy futures. Southwest Airlines very notoriously, during the spike-up in prices, they had bought jet fuel futures or oil futures or something that allowed them to have a competitive advantage because they had built in a hedge against the risk of higher prices at a time when prices did go higher. But here, you are talking about eliminating from the very marketplace the people who might most benefit from being able to hedge, because they don't know for sure whether the movie is going to be a hit or not. Therefore, if they could sell futures on it, they would take away the reward of the smash hit, but they would also eliminate the crash of the total dud.

So it seems to me that the bottom line here is that we are not really talking about a commodity. We are talking about each individual unique product, and the very people who would benefit from commodity futures trading would of necessity have to be excluded because they could manipulate it.

Mr. BERKOVITZ. I think your point is well taken. An oil company is another example. The people inside an oil company are allowed to trade on what they believe will be the price of oil. They may have specific knowledge about whether a field is coming on or not. They might have superior knowledge of what is going on in the oil market, but presumably those traders do not have knowledge of exactly what the price on the New York Mercantile Exchange would be. So, *per se,* it is not illegal or unlawful for somebody with knowledge about the commodity to trade on the commodity.

Mr. GOODLATTE. Sure. But like we said earlier, one barrel of oil is not much different than the next barrel of oil. But one motion picture is completely different than the next one.

And then it is also subject, wouldn't you say, to manipulation by people who are not actually engaged in the production of the movie? For example, movie reviewers or entertainment companies that can play up the movie on their television networks, or on the Internet, or in other marketplaces? They also could say, "Well, let's buy some futures in this movie, and then let's really push the heck out of this movie to try to drive up the box office." Or, "Let's buy futures, and then let's pan the movie and see if we can drive it right down through the floor and make a profit on selling the failure of the movie."

I don't trade in commodities, so I don't know the puts and options and so on that are involved here. But nonetheless, it seems to me that a lot of people could try to profit from this and manipulate it, whereas there is only so much you can say about an ear of corn or a barrel of oil, or a quantity of some other source of en-

ergy or food, or even a currency like the Euro dollar or other things.

Mr. BERKOVITZ. Indeed, the concerns that you have mentioned about the potential for manipulation, the different characteristics of these contracts that you have mentioned, we will be looking at all that very closely in the product review. We have initially, as a condition of the approval of the exchange itself, have the firewall. But whether that is sufficient or not in light of these particular contracts is something that we are going to be looking very closely at to address those very concerns that you have raised.

Mr. GOODLATTE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Chairman Peterson.

Mr. PETERSON. Thank you, Mr. Chairman. So in your view or the Commission's view, the movies are a commodity?

Mr. BERKOVITZ. We are looking at indeed whether to approve these as contracts for future delivery.

Mr. PETERSON. So if you decide, if you approve this, then you are deciding they are a commodity?

Mr. BERKOVITZ. If we were to approve it.

Mr. PETERSON. And apparently you are thinking about having anybody who knows anything about this prevented from trading in it, from what I understand?

Mr. BERKOVITZ. I want to draw the distinction. The current firewall is between the people who actually know what is the number of the box office receipts.

Mr. PETERSON. I understand. But there has also been discussion of trying, excluding anybody that has anything to do with the movie business.

Mr. BERKOVITZ. We are considering whether the current exclusion is broad enough.

Mr. PETERSON. So what you are basically talking about, then, is authorizing gambling. I mean, maybe it should be regulated by states or something. I mean, if you include anybody that is involved in this, then the only people you will have left are people that are gambling on this, basically. Right? I mean, I am just trying to understand what is going on here.

Mr. BERKOVITZ. If we determine that the contract, with whatever conditions that may be placed on it, satisfies the conditions of the Commodity Exchange Act and our regulations, then it will be permitted to be traded on these exchanges, if we make that determination for these products.

Mr. PETERSON. So can there be other derivatives created off of these, then? If these are approved, would you be able to have credit default swaps be set up to further make bets against what is going to happen or to protect?

Mr. BERKOVITZ. Well, if somebody created an instrument that would fit the definition of a *swap* under current law, we would have to look at the instrument. But that might be something that would not be within our jurisdiction, because it would be excluded from our jurisdiction if it fit the definition of *swaps* and it was traded by people who could trade the swap, the eligible contract participants. So it would certainly be possible to create a swap derivative.

Mr. PETERSON. Is that being done now at all?

Mr. BERKOVITZ. I wouldn't have knowledge of that.

Mr. PETERSON. I mean, they raise money to finance these movies. I don't know, I guess that would be one thing. I don't know who can tell us that.

Mr. BERKOVITZ. Presumably, under current law, if somebody were to create a swap rather than a futures contract based upon movie box office receipts, and sell it to only the people who met the statutory criteria, sophisticated parties, called in the Act, *eligible contract participants,* then that would not be something if they traded it under the—according to the way the Act specifies, that would not be something within our jurisdiction. They could do that. That would be outside the CFTC's jurisdiction.

Mr. PETERSON. Unless we pass a bill here.

Mr. BERKOVITZ. Exactly.

Mr. PETERSON. And the Senate apparently, in the bill that they have moved out of the Agriculture, Nutrition, and Forestry Committee, has put a prohibition on these contracts. Is that correct?

Mr. BERKOVITZ. That is my understanding.

Mr. PETERSON. Have you looked at the language of that?

Mr. BERKOVITZ. We haven't seen the final language. We understand that that provision is in there, but we haven't seen the final language. It was just reported out yesterday.

Mr. PETERSON. And we can do that, the Senate, in legislation? We can ban a particular type of contract?

Mr. BERKOVITZ. You can exclude. Right now in the Act onions are excluded from the definition of *commodity*. So, certainly, Congress can put it in the definition of *commodity* and Congress can take it out.

Mr. PETERSON. That is how they have done it. They have said that movies are not a commodity.

Mr. BERKOVITZ. I believe that is what they have done for the box office receipts, I believe they have taken it out of the definition of *commodity*.

Mr. PETERSON. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. The chair now would recognize the gentleman from Missouri, Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Berkovitz, can you give me a definition of what you believe a movie or a motion picture that would be something that you could put on the exchange?

Mr. BERKOVITZ. The definition of a *motion picture?* We have not—CFTC has not undertaken to define what a motion picture is.

Mr. LUETKEMEYER. To me, that is a pretty important point. We have a motion picture now. It can be anything from what we believe is the big blockbuster, *Avatar*, all the way down to—it listed here a while ago a documentary, X rated movies, cartoons. And by your box office receipt thing, it has to be on 600 movie screens. We have made-for-TV movies which generate income from the standpoint that they are put on TV and advertisers pay to have their advertisements shown during a showing of that movie. Is that going to fall under the definition here of somebody that could actually trade a contract on a movie that is being made for TV; and, if we don't generate enough advertising revenue to pay for the production of the movie, that the producers are covered? Is that some-

thing that could also be construed here to fall under your definition of *movie?*

Mr. BERKOVITZ. The contract terms—when I talk about our product approval, the approval of the contract terms, each of these contracts, they are contracts for future delivery. They have specifications in the contract, what can be traded, which types of movies can be traded. And—I don't have the application right in front of me, but it is specified in the application. So that is part of what we are reviewing, is what are the movies or what may be that will be the subject of these contracts, whose box office receipts will be something that will be put on the exchanges of contract for future delivery.

So that is something we are looking at, what is going to be subject to these box office receipts.

Mr. LUETKEMEYER. Well, to me it seems like that is—you are going to have to nail down the definition of what a motion picture is, because I think you can construe it to be any of those things that we just mentioned. I mean, we are talking about documentaries which take a lot of monies to produce sometimes; X rated films, somebody is going to go out there and produce one of those and want to protect themselves; you have cartoons. All those things are types of motion pictures that if they fall under your definition here of 600 movie screens, I mean, can you look at a TV screen as a movie screen?

I think that at this point your terminology is going to have to really be nailed down a little bit more confining. I mean, right now we have this language so broad that that whole list of things we are financing everything that can be put on a movie screen, including what goes on a TV, in my judgment, from what you see here. It is very concerning to me.

Right now, is there a defined market? Is there some folks out there that really want to trade in these things right now? Or is the Cantor Group just hoping that there is going to be something happening? Is there really a defined group out there that is looking to try and take the risk off of these folks?

Mr. BERKOVITZ. I think the witnesses on the second panel might be in a better position to answer that. Our role is to determine whether, in fact, these products, and some of the issues you have described, meet the specifications in the Act.

Mr. LUETKEMEYER. Let me ask this question then. What do you see as an inherent problem from your standpoint at the CFTC?

Mr. BERKOVITZ. Our role is to ensure that any contracts that are traded on our regulated facilities are not susceptible to manipulation; that there are appropriate position limits on these contracts to ensure that no single entity has too great a share of the market and then can influence the prices by having too great a share; or—and that the settlement process, the process for determining that the final price of these contracts, the box office receipt number, that that process has integrity and that is a reliable number and the market can have confidence that it is accurate. And that is really our statutory role, that we have been directed to do under the Act.

Mr. LUETKEMEYER. Mr. Peterson asked a while ago, and a couple other folks referred to, the numbers of people who have access to

the movie production, whether it be the actors or anybody who works on the sets, the writers, whomever. All those folks at this point are not prohibited from being able to participate in this? Are you looking to try and do that?

Mr. BERKOVITZ. We are looking to draw the appropriate firewall, if you may, between the people who have actual knowledge of the box office receipt numbers who will know what that price is, and to ensure that they will not be able to trade or give information to others who are trading. Whether that is the full extent of the separation, that is something that we are looking at in this product approval process.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. The chair recognizes the gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. I was out for a little while meeting with some folks, so I may be asking questions that have been already asked and answered. If I do, I apologize for that.

It is hard for me to see who takes the other side of this product if you don't exclude insiders. So the movie is in production, something occurs, it looks like it is just not going to produce. Basically, the house is on fire but we are the only people who know it, so we are going to rush out and buy insurance. Well, I would be a fool to be the other side of that deal, and I think the market would pretty quickly conclude that this is too dangerous and could really get stuck as a result of the fact that people will have unique knowledge about whether to buy or to sell concerning this particular product.

And so from a packaging perspective, I could see those who are interested in offering the product trying to sanitize it so that it behaves more like regular futures and commodities that you wouldn't have inside information along those lines. I am a little surprised, though, that the CFTC is, as part of the approval process, coming up with this firewall concept. Can you give us examples of other products where you have firewalls? Is this sort of a new concept for these products? Or are there other products where you have firewalls? I know CFTC personnel specifically can't invest and other people who have unique knowledge, the owners of the exchange, things like that. But beyond that, can you pick a commodity where the CFTC has imposed some sort of firewall concept like this?

Mr. BERKOVITZ. I believe it is a new type of condition.

Mr. MARSHALL. Well, I don't like the fact that—we are very clumsy with our efforts to legislate in this arena. Witness the fact that we have an exception for onions, for God's sake. I don't think we really want to set up some regime where everybody is running to us because they are worried that some product might be approved inappropriately by the CFTC. And so we start adding to the list. It is now onions and now it is movies and now it is whatever. I don't know what it is going to be.

So it seems to me the CFTC needs to help us out here in coming up with some principle, or the parties here need to come up with some principle that can guide the CFTC and guide Congress in concluding: Yes, this is an appropriate product, or no this is not an appropriate product. And I just don't see how firewalls cut it. It is a license to lie is basically what it is. It is hard for me to believe that

the other side to the deal, being sophisticated parties, would believe that the firewalls would actually work. That you think you need a firewall suggests that you are worried about all kinds of manipulation issues. It is one thing for the party that is putting together the product to feel like it needs to have a firewall because nobody is going to buy the product otherwise. It is another thing for the CFTC to say there has to be a firewall. That suggests to me that the CFTC has a very limited confidence in the product; or, the CFTC is worried about manipulation, that this is an extraordinary—too focused, maybe too much of a rifle shot kind of product here, where it would be just too easy for people to manipulate the price and, consequently, the market, that very small market.

So I would like you guys to come up with some principle other than firewalls. I mean, if firewalls don't exist for any other commodity, it seems to me a big stretch for the CFTC to say, well, we are going to come up with this concept with regard to this particular commodity, without maybe a broader discussion with Congress about the CFTC's appropriate role, and whether or not the CFTC should be about the business of approving products with firewalls.

You know, it gets close to sort of wandering into, there is a big difference, or at least historically, as I understand it, a big difference between the SEC's and CFTC's work. Where these exchanges have been concerned, we want insider information. It is all price discovery stuff. So whatever information you can get, you bring it to the table. Where the SEC is concerned, we are worried about insider trading. They have actually got authority to pursue insiders. And you are kind of setting up an insider trading regime within the CFTC without having gone through some legislative process to determine whether or not the CFTC's role should be changed.

I am just expressing my concern in light of the fact that there doesn't appear to be any other product ever approved by the CFTC or any exchange that has this firewall concept in it. Thank you, sir.

The CHAIRMAN. Thank you, Mr. Marshall. You have made some points that we have been hearing about. So I appreciate that.

At this time we would like to recognize the gentlelady from Colorado, Ms. Markey.

Ms. MARKEY. Thank you very much, Mr. Chairman.

So obviously this is brand-new territory, and there is a lot of concern, a legitimate concern, raised here this morning. And let me just take a little different vein.

You have expertise at the CFTC with traditional commodities that are traded, and this is a new product. What kind of expertise do you have on hand right now with your current staff? And how do you plan on developing the expertise that you are going to need in-house to make sure that these products are not susceptible to manipulation?

Mr. BERKOVITZ. Our first defense, of course, will be the exchanges themselves. They are required to police their own markets, that is a condition of our approval of the exchanges; that they have surveillance and they have anti-manipulation processes in place. And both of the exchanges I believe have contracted with the National Futures Association to undertake that, who has the expertise

to do this. They do the surveillance, market surveillance programs for a number of exchanges.

So the exchanges are the front lines in this, and they have submitted their programs to us and that has been part of the approval process. And then on top of that, the CFTC surveillance program is in addition to that. And, indeed, to address that very concern, the market surveillance systems that they are required to have pursuant to the designation criteria, and the core principles are something that we have looked at and found that they are adequate.

So it is not just the CFTC by itself and our staff who will be overlooking these contracts. It will be the exchanges and the National Futures Association also.

Ms. MARKEY. And of course, as you know, Congress is looking at legislation to regulate derivatives. So you will already have a lot more on your plate within the next year. And then this is taking on additional work and an additional commodity. What are your staffing levels like right now, and with the exchange, in order to handle all this additional work regulations that are going to have to be written, staff that has to get up to speed on new products?

Mr. BERKOVITZ. The Congress and the Administration have been very supportive of increasing the CFTC resources in the past few years to meet these additional responsibilities, both in terms of the current volume of futures trading and number of contracts continue to increase; with new products coming on, and then, as you mentioned, with the legislation, which will require substantial new resources. And I believe that is in our budget request.

So it is a very real concern that the agency have adequate resources to undertake both these new markets within existing authority, as well as the new authorities that we may get under the legislation.

Ms. MARKEY. Thank you, Mr. Chairman, for holding this hearing. And I yield back.

The CHAIRMAN. Thank you. The chair recognizes the gentleman from Minnesota, Mr. Walz.

Mr. WALZ. Thank you for being here, Mr. Berkovitz. I appreciate it. I think all of us are trying to get a handle on what is happening here. It is an interesting discussion, and an important one, because the need is always there for financial instruments and innovation, and trying to balance those things out. I am interested to hear from Mr. Jaycobs and the folks from Cantor, kind of an impeccable timing of bringing up a new financial instrument in this environment. But I think that is the nature of it, and we have to be open to be able to hear that.

A couple questions I have in watching this and trying to understand your position, not just on this issue, but a little broader. Do you see yourselves as just a passive pass-through to make sure the rules are enforced exactly as you interpret them? Or do you see yourself to anticipate and be more proactive against those? I am kind of getting the feeling, it seems to me that—and this may be the proper role. I am trying to understand it. That it is just passive, that these are the rules, and they fall within the rules so we have to do it.

Mr. BERKOVITZ. I would describe it as a very active enforcer of the rules that we have. We have the rules and we have to follow the rules. We try to be very proactive, anticipating and looking ahead, to avoid problems, rather than simply looking behind.

Mr. WALZ. I want to make sure that I fall on the right side of this. Do you see it, is it the appropriate role of the CFTC to determine if there is a need for this product? Or is that for the market to determine, those folks who are coming to you?

Mr. BERKOVITZ. It is not within our purview to determine whether indeed there is a need or not.

Mr. WALZ. So that might be kind of at the heart of this. I think some of us are trying to grapple, is there a real need for this, what is it for, and all of that. But asking you to do that is an inappropriate position to put you in. Am I correct? Am I summing that up right?

Mr. BERKOVITZ. That is not something that is one of the criteria for approving these products or not.

Mr. WALZ. I think we are all struggling with this. And it may seem like a very simplistic question, because I am trying to understand this and trying to understand the definition of a question. I don't want to go down the road that the President did at one point on a pejorative towards Las Vegas. But there is a very specific reason for that. And I am trying to understand how this is different than a wager. And I say, for example, is this a bad example of—something like the Minnesota Vikings. They field the team, they put it together. And is there a future trading on how well they do this year? Is that different? Or is that a wager to determine whether they win the Super Bowl or not?

Mr. BERKOVITZ. That is nothing that is traded on any of our futures.

Mr. WALZ. Is it different than this, though, by definition? Is it different than the movies futures? You know, you have a product. You have investors that get in it. You can buy into the studio right now. You can get dividends off that on a regular exchange on the big board. You can do all that. But the performance of it tends to be based on more of a wager because of all of these factors people brought up. That is what I am trying to understand, if this is the appropriate place for it. I think it would be—I am trying to see this. I think it would be appropriate for me, on what I know as a casual observer of movies, about which ones are going to hit big and which ones aren't. But that is wagering, it seems to me. I don't know. I am trying to get that from your expertise on this. It is somewhat subjective.

Mr. BERKOVITZ. We don't really approach the question from that perspective. Somebody comes in with an application and say, "We would like to trade the contract for future delivery or an option on a future for a certain commodity." And we look at that application. We are proactive in whether, indeed, the contract meets the statutory standards, whether it is susceptible or not to manipulation, what are the appropriate limits again and the integrity of the process. So we do a very thorough active review of that as it is presented to us.

Mr. WALZ. So you are operating inside the framework you were given, and I think that is probably appropriate. I think some of these questions are for the next panel.

I thank you for your patience and your willingness to help us understand this. I yield back.

The CHAIRMAN. Thank you. The chair recognizes the gentleman from Oregon, Mr. Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman. I guess I am biased, because I am one of the few Members that do not worship at the grail of liquidity and derivatives in this august body of ours. And while I appreciate what you do and CFTC has a stellar record, it is going to take some convincing to me that this is a good idea. What I have heard so far is it is going to be up to us to decide yes or no, passing legislation, create another onion exemption. I think that is unfortunate. But I see this as ripe for manipulation. I see no overriding public interest in this at all. Frankly, the people that are most affected don't like it, from what I have gathered so far. I guess we will hear more about that, going forward.

To be honest, I think it would be sheer folly. We are in the middle of the worst derivative crisis this country has ever seen since the Great Depression. We are going to create another instrument, one that the public is going to see as, frankly, legalized gambling. I think the person who votes for this sort of thing would be absolutely insane. But maybe I could be convinced otherwise. I look forward to the rest of the testimony. Thank you. I yield back.

The CHAIRMAN. Thank you. Mr. Berkovitz, at the University of Iowa, the College of Business operates the Iowa Electronic Markets. While originally created as a teaching tool for students, this market is now open to non-students and includes trading in elections futures from presidential races to control of Congress to individual races. Small market, with investors limited to $500. But it is a market nonetheless. The Iowa Electronic Markets operations under a No Action letter provided by the CFTC, where the CFTC says it will not take action against the university for offering political futures contracts on their exchange. It seems to me that elections contracts raise many of the same concerns we will hear from the next panel. What is the price discovery or hedging service the contract provides? What is the ability of the industry insiders, in the case of elections that would be pollsters, consultants, media, using their knowledge to trade or manipulate these markets? And what is their utility? For example, is an elected official ever going to short his own election? And granting No Action relief to the Iowa Electronic Markets, did the CFTC look at these issues? And why are these markets permitted?

Mr. BERKOVITZ. My understanding on the Iowa Electronic Markets is this is being done and overseen by the University of Iowa as an academic and a research undertaking. There is a dollar limitation on it. It is being supervised by the university. My understanding, it is not for profit as well. Under those circumstances, the CFTC granted the No Action letter to enable it to operate.

The questions that you have raised, though, in terms of the broader, beyond Iowa, are questions that do concern the Commission. In 2008, the Commission issued what is called a concept release, sort of like a discussion paper. It was in the *Federal Register*

notice, inviting public comment on some of those very questions: What should the Commission's position be with respect to these, what they call prediction markets, where you can theoretically predict the outcome of an election or over events?

And what should the regulatory position towards these markets be? Should we have an active role and regulate them like futures contracts? Are they inherently different from futures contracts? We have numerous public comments on that, and we are still reviewing that issue at the Commission.

The CHAIRMAN. Any other questions from anybody on the dais? Seeing none, thank you very much for sharing. And we would like to excuse you at this time and invite the other panel to take their place.

Thank you, gentlemen. We will just go through each and ask you to make your statement, if we could. And we will ask that you consider the 5 minute rule. We would like to hear from you, and then we will have an exchange of questions.

So we would like to start off with Mr. Jaycobs, President of Cantor Futures Exchange, New York.

STATEMENT OF RICHARD JAYCOBS, PRESIDENT, CANTOR FUTURES EXCHANGE, L.P., NEW YORK, NY

Mr. JAYCOBS. Thank you, Chairman Boswell, Ranking Member Moran, and Members of the Subcommittee. Good morning. I am Richard Jaycobs, President of the Cantor Futures Exchange.

We have been working on the development of a futures exchange for box office receipts for over 2 years, but it wasn't until the last 4 weeks that we received any attention at all on the subject. And I welcome the opportunity to help alleviate the concerns and put into the proper context what we are building, how it works, and what benefits can be achieved through this.

I would like to emphasize three points about the economic purpose and the integrity of futures contracts on box office receipts. First, for the private and institutional investors who have invested up to $8 to $10 billion of private money in films, futures contracts can be an important risk management tool just as they are in agriculture, energy, and many other industries. Movie futures will make more capital available at lower cost and, as a result, create American jobs.

Second, Cantor Futures contracts are an effective pricing tool. The anticipated box office revenue of a motion picture is the basis upon which many decisions and commitments are made. By establishing this exchange, a market mechanism is created to provide independent judgment of that anticipated revenue, and it gives participants in that market and others better information. For example, screen allocations by movie theaters, distribution terms by independent distributors can be negotiated in the full transparency of a public price.

Third, as a regulated futures exchange, we observe all market activity. Together with the National Futures Association and the CFTC, we have proper and prudent safeguards against manipulation. Cantor Exchange takes the issue of market integrity and transparency very seriously. Our parent company, Cantor Fitzgerald, was founded in 1945, and has extensive capital market ex-

perience. Cantor supports this Committee's efforts and goals for financial regulatory reform through greater market transparency, competition, and centralized clearing for financial markets.

We are proud of our long record as a responsible market participant and a reputation as a caring corporate citizen in the aftermath of the 9/11 tragedy. In the wake of our nation's financial crisis and the debate on financial reform, any new financial product clearly should come under scrutiny.

Since 2000, CFTC has designated more than 10 new exchanges with the creation of over 1,000 new futures contracts. As an experienced and expert regulator, the CFTC is well equipped to consider the public utility of new futures contracts and to ensure that any proposed futures contract meets the public policy, anti-manipulation, and fair competition requirements of the law. The box office contract will not proceed without CFTC approval and the legislation on this issue is not needed.

The MPAA has said that movies futures are not legitimate, that they create an online platform for gambling, and that they are susceptible to manipulation. These are inaccurate and overreaching statements. The revenue generated by millions of moviegoers can be determined directly from the published reports of distributors or estimated from the electronic sales records.

Initially, Cantor intends to use the box office numbers released by the studios; however, if the accuracy of the studio data appears to be manipulated, we will be able to detect this by comparing it to electronically captured sales records. Publicly available information enables the market to develop reliable estimates of a film's future box office potential, and in fact, several commercial entities already exist to make box office forecasts based solely on public information.

The MPAA has also said that futures contracts based on box office receipts have no economic purpose. However, Lionsgate Entertainment, one of the most successful film distributors in North America that is not a member of the MPAA, has said in its letter to the committee, "A market in domestic box office receipts would substantially widen the number and breadth of financing sources available to the motion picture industry by lowering the risk inherent in such financing." This is a key point. While the six MPAA members may not appreciate the value of film futures, other studios, producers, distributors, exhibitors and investors certainly do. Many sound, commercially important regulated markets would not exist today if large entrenched interests could simply have blocked their creation.

The community of private and institutional investors who currently finance a significant percentage of domestic film production have no access to a risk mitigation tool. They have no voice here in front of this panel today. They have no trade association that represents their interest. We believe this group alone satisfies the requirement for a group of hedgers.

In closing, better transparency is a critical component of a well-functioning market. Futures exchanges have proven their worth by bringing transparency and greater price discovery to market participants. The box office contract is designed to accomplish that same goal. When fully implemented, the market for these contracts

will benefit all participants in the motion picture industry by providing additional capital at lower cost.

In closing, what I would like to reference now is that injected into the regulatory reform debate in the Senate of course is the language prohibiting this contract. We obviously would like to express our view that we oppose that. Thank you for the opportunity.

[The prepared statement of Mr. Jaycobs follows:]

PREPARED STATEMENT OF RICHARD JAYCOBS, PRESIDENT, CANTOR FUTURES EXCHANGE, L.P., NEW YORK, NY

Thank you Chairman Boswell, Ranking Minority Member Moran, and other Members of the Subcommittee. I appreciate the opportunity to appear today and to submit written testimony on the application of the Cantor Futures Exchange, L.P. ("Cantor Exchange") to the Commodity Futures Trading Commission ("CFTC") for designation as a contract market, and to discuss the public utility, transparency, and risk management benefits of Cantor Exchange's proposed movie box office futures contracts. Cantor Exchange's futures contracts are designed to bring risk management, transparency and financial flexibility to a wide range of participants in the film industry, similar to the role of regulated futures markets in agriculture, energy products, financial instruments, and other sectors of the marketplace.

Introduction to Cantor Fitzgerald and the Cantor Exchange

I am here today in my capacity as the President of the Cantor Futures Exchange. Our parent company is Cantor Fitzgerald, which began as an investment banking and brokerage business in 1945. Following the loss of 658 of its 960 New York-based employees in the 9/11 World Trade Center attacks, Cantor rebuilt to become one of the leading and most widely-respected global financial services firms, recognized for its leadership in serving institutional clients in the fixed income and equity markets and for capital markets investment banking. Driven to succeed in order to help the families of its employees who perished on September 11, Cantor provided over $180 million to the families over five years, including healthcare benefits for 10 years for the families that needed it. In addition, to commemorate those who were lost, Cantor and its affiliates forego all their revenues each September 11, donating the full amount to charities that help wounded veterans, children with medical and special needs, and other worthy causes. Turning a tragic day into something positive and uplifting, these annual Charity Days to date have generated over $50 million for charitable organizations. Over the past eighteen months, as the financial markets experienced substantial turmoil, Cantor has added hundreds of new jobs, continuing its expansion and growth during a most difficult time in the global capital markets.

Cantor Fitzgerald is one of 18 primary dealers authorized to trade U.S. Government securities with the Federal Reserve Bank of New York. Cantor Fitzgerald has been a major participant in the futures markets and has itself sponsored futures exchanges in the past. Indeed, Cantor Fitzgerald has been involved in operating futures exchanges since 1998. Cantor Exchange's affiliation with Cantor Fitzgerald underscores Cantor Exchange's capability and expertise to professionally operate, finance and monitor a well-run, efficient, federally regulated futures exchange.

Cantor Exchange's Movie Box Office Futures Contract

Cantor Exchange has submitted an application to the CFTC to establish a futures market for contracts linked to the domestic box office receipts ("DBOR") of upcoming film releases. These contracts will be cash-settled at a value that is directly indexed to the dollar value of movie tickets sold in the U.S. and Canada that consumers purchase over a period of approximately 4 weeks.

The goal of Cantor Exchange has always been to assist the motion picture industry by expanding the breadth and depth of financing sources available to the industry. Enlarging the potential sources of film financing will lower the cost of making a film, help create American jobs, and contribute to stabilizing large and small members of the industry alike as they face the challenge of raising financing in the high-risk endeavor of filmmaking.

We believe that a critical element in this effort is a public, transparent, and appropriately regulated futures market. It's important to point out that the film industry consists of many participants. In addition to the major studios, they include mini-majors and other smaller studios, independent producers and distributors, theater owners and investors. I've talked with a great number of them in the past weeks and months, and it's absolutely clear that there is wide and deep support for

the ability to hedge theatrical risk and that hedging capability will drive a fundamental improvement in film finance.

Our box office receipt contract is a straightforward hedging vehicle. It is an important design feature of our contract that box office receipts are a real and knowable value, based upon credible marketplace data. DBOR contracts are structurally identical to cash-settled futures contracts on many economic indices that similarly provide for cash payments based on real underlying economic value. In the case of DBOR contracts, settlement is based on the aggregate box office receipts of the underlying film as reported by the distributor of each film and captured by Rentrak Theatrical.

DBOR contracts are not a direct investment in film, but rather a cost effective means to hedge the extraordinarily high risk of the movie-going public's willingness to pay between $5 and $15 to watch any single film. Some films, like "Avatar", generate audiences and revenue that not only have strong openings but sustain their financial strength over a protracted period, whereas the audience for films like "Gigli" and others evaporated quickly as consumers shift their preferences to better movies. The transparency offered by a regulated public market and the ability to hedge risk has indisputably been shown to result in reduced capital costs and greater competition, and that is the function and value that we propose to bring to the marketplace.

We believe one of the immediate beneficiaries of our DBOR futures contract will be investors who provided the capital investment to make these films and are locked into multi-year, illiquid investments. Then, we expect the transparent public pricing and commercial potential of DBOR contracts will be recognized by theater owners to help reduce revenue volatility across their business by hedging their exposure to film-release volatility. We believe that every segment of the motion picture industry will ultimately find value in using box office receipt futures to hedge risk and broaden access to less expensive financial resources.

While the Motion Picture Association of America, the MPAA, has raised concerns about our contract's usefulness as a hedging vehicle, it's often been the case in the history of the markets in our country—the oil and aluminum industries are notable examples—that industry participants that initially resisted change came to see the futures market as an instrumental element of their industry's business and financial practices.

Comprehensive Regulatory Review Process

Cantor Exchange has been working with the CFTC on its application to become a designated contract market. For over two years, Cantor has worked diligently with two staff teams of the CFTC to comprehensively demonstrate why box office futures satisfied the CFTC's Core Principles as required by the Commodity Exchange Act, including the ability to adequately prevent market manipulation and enforce equitable access and trading rules. I want to emphasize this point: our proposed exchange has proper and prudent safeguards against trading on inside information consistent with CFTC requirements. Indeed, these issues had been the subject of intense scrutiny by the professional staff of the CFTC and, by all accounts, had been successfully addressed in the application process.

Our application was formally submitted to the CFTC on November 28, 2008. A public comment period on our exchange was held by the CFTC during January 2009 and no comments were received. A second public comment period on the subject of box office receipt contracts was available to the industry in October 2009 when Media Derivatives applied for designation and again no comments were received. The CFTC's review of Cantor Exchange's application is substantially complete and a decision on our application is expected this month.

Despite receiving no comments during either public comment process, we are here today at the first ever Congressional hearing on an exchange application in the history of the CFTC because a segment of the motion picture industry has raised public policy objections at the eleventh hour to any form of futures contract based on domestic box office receipts. We think it is clear that the assertions of the MPAA are groundless.

The law and regulations of the United States are clear and unequivocal about fair trading rules, market surveillance, compliance and enforcement to ensure financial integrity and transparency of futures markets. As an expert agency and regulator of futures markets, the CFTC is well-equipped to consider the public utility and transparency that box office receipt contracts will bring to the motion picture industry. The CFTC has adequate authority to ensure that any proposed futures contract meets the public policy, anti-manipulation, and fair competition requirements of current law. The CFTC does not need further legislation or regulation to make an appropriate determination of this issue.

Since enactment of the Commodity Futures Modernization Act in 2000, the CFTC has designated over ten additional futures exchanges as contract markets, including Trend Exchange (Media Derivatives) on April 16, 2010. The CFTC has also registered at least nine clearinghouses as "derivatives clearing organizations" during that time. Countless new products have been filed with the CFTC since enactment of the CFMA, with the majority "self-certified" by exchanges for immediate trading. None of these innovative exchanges or the products that they self-certified under the watchful eye of the CFTC has been associated with any form of systemic risk or financial stress.

We expect that the creation of futures contracts based on box office receipts could dramatically lower financing costs for motion pictures; we expect that futures contracts could act as an engine for overall growth in the motion picture industry; and we expect that small and independent firms and financial investor partners would benefit considerably by having a hedging vehicle.

We did not expect, however, the inaccurate, over-reaching and extraordinary claims of gambling, manipulation, and commercial damage made by the six largest studios' trade association, the MPAA, on March 23. Through its unfounded and insupportable assertions, the MPAA essentially has impugned all futures trading, attacking the practices of the energy, aluminum, agricultural products and other industries as equivalent to gambling and marketplace manipulation.

Cantor Exchange appreciates the opportunity to address these assertions with the Subcommittee. The primary purpose of my testimony today is to reinforce to the Members of this Subcommittee the sound and sensible answers that were presented to CFTC staff over the last two years. In so doing, our hope is that the Subcommittee recognizes the careful, thorough and considerable effort that both Cantor Exchange and the CFTC have put forward to ensure that Cantor Exchange and the DBOR contracts meet the letter and the spirit of the Commodity Exchange Act and, just as importantly, represent a positive innovation for the motion picture industry.

Economic Purpose of Box Office Contracts

The motion picture industry is undergoing radical transition brought about by changes in film distribution technology, the Internet, and the ongoing financial crisis. All of these factors have combined to partially destabilize this very important American industry. The number of motion pictures produced in 2009 dropped dramatically by 12%, the first decline since 2003. Bank financing for films has all but ceased, over ten independent film companies either ceased doing business or consolidated their operations over the last 24 months, and the number of jobs lost by the film industry is estimated to be in the thousands.

A public market for futures contracts based on domestic box office receipts will not by itself reverse these trends. However, DBOR contracts will provide a fully transparent and highly regulated marketplace where the risks of film investing can be shared and financing costs can be lowered.

There are currently no mechanisms for firms in the motion picture industry to hedge risk associated with new film releases and, accordingly, there are no open and transparent markets for such transactions. A panoply of banks, institutional investors, and individuals place capital into various film financing vehicles and are exposed to unhedged box office risk. Other participants in the industry including distributors, theater owners and film studios themselves also have substantial unhedged exposure to a film's box office performance.

Investing in film production and distribution is extremely risky. Motion picture finance has failed to find a sustainable investor base due to the great uncertainty of film performance at the box office. Particularly in times of economic uncertainty, the high variability and risk of returns means that identifying sources of film financing quickly becomes difficult.

The ability to finance films and manage the risks associated with film finance varies greatly. The major studios may be least affected by financial stress. Owned by large corporations, they benefit when fewer films are produced and there is less competition for movie goers, and they have the greatest leverage in negotiating revenue splits with theater owners.

Weakest among the risk bearers include the financial investor who places capital in a multi-year film fund, the small theater owner who commits screens to major studios based solely on representations of those studios, and the production company that has little control over the marketing and distribution of its film. We submit that these commercial interests, combined with non-MPAA studios, represent a large enough and significant hedge community to meet the requirements for economic purpose under the Commodity Exchange Act.

In addition to the extensive support for futures contracts we have identified amongst this section of the industry, there also is support by some of the larger

players in the motion picture industry. Michael Burns, the Vice Chairman of Lionsgate, one of the leading independent film studios with a major presence in producing and distributing motion pictures, submitted a letter on April 16 to the House Committee on Agriculture in support of DBOR futures. Mr. Burns indicated that the regulated futures market proposed by Cantor Exchange "would allow a diverse group of motion picture industry participants, including studios, film distributors, theater owners, investors and other financial intermediaries within the motion picture industry to manage their risk and exposure to new film releases." Mr. Burns added "We believe a market in domestic box office receipts would substantially widen the number and breadth of financing sources available to the motion picture industry by lowering the risk inherent in such financing." We also understand that despite the National Association of Theater Owners signing various letters of objection, individual theater owners representing almost 20% of all theaters in America wished to see DBOR futures made available and not restricted as a result of any regulatory or legislative action.

With respect to price discovery, the MPAA asserts in its March 23 letter that DBOR contracts would not serve this public purpose; however, the MPAA subsequently submitted another letter on April 8 in conjunction with other film industry associations which explicitly recognizes that commercial transactions are affected by the pricing of film revenue contracts. Specifically, the April 8 letter stated that "[m]any prices for downstream licenses and other sources of revenue are driven in part by box office gross".

Transparency of information can only be a positive for any market. For eight years, Cantor Fitzgerald's virtual entertainment marketplace, the Hollywood Stock Exchange ("HSX"), has found that its hundreds of thousands of participants have not negatively impacted the virtual market domiciled on HSX.

In contrast to unfounded claims by the MPAA, and because of the many economic interests and legitimate hedgers that have directly or indirectly expressed support for the existence of a market in box office futures, we submit that this market should be allowed and encouraged to exist.

Box Office Contracts Have Safeguards Against the Risk of Manipulation

Cantor Exchange and its DBOR contracts will be monitored and policed like any other CFTC regulated market. To support its own compliance efforts, Cantor Exchange has engaged the National Futures Association ("NFA"), the industry-wide self-regulatory organization for the U.S. futures industry, to provide the exchange with self-regulatory services to monitor trading and protect against market manipulation and other abuses. NFA has demonstrated its ability to safeguard and protect the public interest in markets as broad and diverse as carbon futures markets and the foreign exchange markets.

The final settlement value of a DBOR contract represents the movie ticket purchases of millions of American consumers over a period of approximately four weeks. These purchases are reported by movie theaters, tabulated by Rentrak Theatrical, and published by studios. Therefore any effort to manipulate the DBOR contract's final settlement value would require tens of thousands of ticket sales to be under or over reported. It is hard to accept that such a large scale reporting gap could go undetected by all these commercial entities. For example, studios compare pop corn and soda sales to ticket sales as a check against under reporting. Even if such a fraud was attempted using box office futures, the beneficiaries of any such manipulation of the final settlement value would be quickly detected by Cantor Exchange, the NFA, and the CFTC. As Lionsgate's Mr. Burns indicated in his letter to the Committee, "Lionsgate is comfortable that the market for futures on box office receipts can be adequately policed regarding material non-public information and attempted market manipulation. The Cantor Exchange, under the CFTC's rules, will restrict trading by those with material non-public information relating to film releases."

Manipulation is often associated with trading on material, non-public information. Clearly, certain institutions that may have an economic interest in hedging with DBOR contracts will have access to material non-public information relating to the underlying film title. This is not different from the situation in other public markets where trading activity is walled off from those who have material nonpublic information.

Currently, the entertainment industry has no such barriers and has expressed concern about how such barriers might impact their operations. Cantor Exchange would like to emphasize three key points on this issue: (1) information barriers will not be required unless an entity is actively using the market; (2) having knowledge of the artistic content or prior viewing of a film does not constitute material non-public information; and (3) Cantor Exchange will work to assist any firm that wish-

es to prohibit its employees from trading. For example, Cantor Exchange does not permit trading by any employee of a FINRA or CFTC regulated entity unless that employee has the written permission of his employer's compliance department.

Commercial Value of DBOR Contracts

As I noted, the financing and distribution of motion pictures is undergoing a period of enormous technical and financial change. Studios largely control the distribution of films and are uniquely able to fund the large advertising budgets so crucial to a film's box office success. Recently studios have abandoned many of their boutique divisions that distributed independent film, focusing instead on blockbusters.

However, digital distribution of motion pictures will make it easier for movie theaters to show smaller independent films. The missing element for independent film makers and distributors is a means to evaluate the commercial potential of their film and secure financing against that potential. This is exactly the role that a futures market based on box office receipts can play.

The financing of motion pictures is now coming from many new sources including corporate sponsors who may back individual film projects as part of their brand marketing. As the sources of film financing become more fragmented, the need for a regulated and transparent futures market increases.

Hollywood studios have hedged their film making risk for many years, for example, by buying insurance against bad weather during outdoor filming. In spite of its glitz and glamour, the motion picture industry is relatively opaque. We suspect that the MPAA is primarily concerned that a transparent market in film revenues will detract from its influence and control of market information, hence its disingenuous claims that futures trading has no commercial value.

We also recognize that the MPAA's concern seems to be a knee-jerk reaction to change, just as companies in the oil, aluminum and other industries initially opposed the establishment of futures markets, but now find them to be useful and customary aspects of their industry's commercial practices.

There is no question that a public market for DBOR contracts will shine a brighter light on the motion picture industry. Allowing a greater number of market participants to signal their expectations about the market by allocating their capital will result in a more accurate assessment of value. We believe this greater transparency could benefit many participants in the industry. For example, purchasers of downstream licenses pay prices based on box office receipts or based on expected box office receipts if contracted in advance. DBOR contract pricing could constructively benefit those negotiations by providing new information to the downstream counterparty that currently has to rely on less public and less transparent sources.

Conclusion

Enlarging the potential sources of film financing will lower the cost of making a film, help create American jobs, and contribute to stabilizing large and small members of the industry alike as they face the challenge of raising financing in the high-risk endeavor of film making. A marketplace that enables film makers to raise capital at a known price will reduce risk and increase the likelihood of bringing their product to market.

The MPAA asserts that its objection to DBOR contracts is based on its belief that those contracts will not provide a genuine market for hedging risk or contribute to price discovery. As my testimony has shown, these critiques are misguided.

It is ironic that while transparency in financial markets is widely endorsed in legislation and Congress is promoting regulated futures exchanges and centralized clearing, the MPAA's objections would result in less transparency, increased counterparty credit risk, and fewer financing options.

Since the early stages of our process to establish the Cantor Exchange, we have actively sought out the input of a wide range of individuals and entities throughout the motion picture industry. Many of those we have reached out to have expressed interest in the concept of DBOR futures contracts. We have received considerable useful feedback and have continued to refine our business plans and strategy.

An April 8, 2010 press release by the Futures Industry Association, the leading trade organization for the futures industry, urged that the potential introduction of film revenue contracts should be "applauded rather than criticized".

We encourage the Subcommittee to ensure that the CFTC continues its diligent work to review and allow transactions to be executed and cleared in regulated and transparent venues. The legislation is already in place to allow Cantor Exchange to operate a futures market in DBOR contracts in accordance with the Commodity Exchange Act, and its application should be approved promptly.

Greater transparency, reduced counterparty risk, and broader participation are precisely the benefits that Congress, economists and others have cited in recom-

mending improvements in the financial markets. During the financial crisis of 2008–2009, most agree that the futures markets performed their function properly. We urge the Subcommittee to support creation of this new, constructive, federally regulated futures market that will enhance the motion picture industry's transparency, market integrity, and ability to effectively manage commercial risk.

We believe our application for contract market designation and for approval of the futures contracts based on box office receipts is clearly in the public interest. Our innovative proposed futures contracts on box office receipts offer many in the motion picture industry the ability to hedge their commercial risks and will be used for price discovery purposes. Although not all interests in the motion picture industry may be inclined to trade box office contracts for these purposes, others stand to benefit greatly from their availability. This has often been the case at the time a new class of futures contracts was introduced.

Prohibiting futures on motion pictures by changes to the Commodity Exchange Act or by new laws or regulations could deny this critical industry a tool available to manage capital and allocate risk more effectively. While all forms of financial innovation should be carefully assessed to determine their value to the marketplace and the public interest, we are extremely confident that the current Commodity Exchange Act and CFTC regulations fully and adequately address all the issues that have been raised by certain groups within the motion picture industry for the Subcommittee's consideration.

On behalf of Cantor Exchange, thank you for this opportunity to discuss how our proposed futures contracts will bring new levels of risk management, transparency and financial flexibility to the motion picture industry.

The CHAIRMAN. I now recognize Mr. Swagger, Chairman and Chief Executive Officer, Media Derivatives of Scottsdale. Mr. Swagger.

STATEMENT OF ROBERT S. SWAGGER, CHAIRMAN AND CEO, MEDIA DERIVATIVES, INC., SCOTTSDALE, AZ

Mr. SWAGGER. Thank you, Chairman Boswell and Ranking Member Moran for inviting us here to testify. I am Robert Swagger, Chairman and CEO of Media Derivatives. Media Derivatives is a small, privately funded entrepreneurial business that has followed the processes and procedures established in the Commodity Exchange Act, and in so doing, has created jobs during a challenging time in the U.S. economy.

As an individual who was born in the Midwest and has experienced the benefits of futures markets to the agricultural industry, and in particular, as an entrepreneur who helped found an ethanol plant that its very survival was a direct result of the use of futures contracts, I have founded MDEX for the purpose of creating risk management tools for the entertainment industry. Note, the concepts of creating such tools was a direct result of my and my team's extensive involvement in the entertainment industry. We believe that the development of such products is consistent with the major thrust of the Congress' enactment of the Commodity Futures Modernization Act of 2000 which sought to promote, among other things, innovation with respect to risk management tools and futures contracts.

On September 25, 2009, MDEX filed its application to become a designated contracts market. At the time of its filing, MDEX agreed to separately file its proposed products for approval rather than self-certifying. In early March 2010, MDEX filed its first product for review. On the eve of the expiration of the CFTC's 180 day review period and more than 4 months after the close of the comment period for DCM application, various entertainment industry associations filed general objections. Most of the objections are the

same objections that Congress and this Subcommittee in particular has heard for decades. The objections have been addressed by CFTC staff throughout the rigorous review process.

The objectors have contended that the reputation and integrity of our industry could be tarnished by allowing trading in the movie futures contracts. This is patently false. MDEX has no interest in disparaging the reputation and integrity of Hollywood. The objector statements could apply to every industry that has a product upon which a futures contract is listed, such as U.S. Government and Treasury futures, the housing industry and housing futures, the insurance industry and weather futures, the listing of aluminum futures and the aluminum industry, the agriculture industry and the listing of corn, wheat, soybeans, and other futures.

The notion that regulated futures contracts tarnish an industry and is tantamount to legalized gambling is outdated and baseless. MDEX is not seeking to establish an opaque OTC market such as what already exists, rather MDEX seeks to bring the same tested benefits of futures contracts such as transparency, price discovery, liquidity, and centralized clearing in a regulated environment.

The contracts that MDEX seeks to list are not dissimilar to other futures and options contracts. The contracts allow parties with financial interests in the movie production and revenue chain to hedge the risks. Such groups include original screenplay owners, debt and equity investors, investment banks syndicating a financing slate, talent involved in the film, studios both MPAA and independents, banks and lenders, insurers of talent and movies, theaters, distributors and co-promotional marketing partners.

The products proposed by MDEX would provide a viable means of broadening the financial tools available to a very significant segment of the economy in an efficient, reliable, and tested model.

In designing its products, MDEX has worked closely with the CFTC staff to reduce if not eliminate the likelihood of excessive speculation in the retail use of its products. MDEX's contracts specifications require each contract to be fully funded. In other words, there is no leverage component; thus, reducing excessive speculation.

At the same time, because they are fully margined and essentially cleared by a CFTC regulated clearinghouse, there is no credit risk. In all material respects, MDEX's contracts obviate risk, they do not create it.

In working with the CFTC for over 11 months and approving MDEX's DCM application, the CFTC found that both MDEX and the CFTC, as well as the NFA have the expertise and resources necessary to conduct market surveillance and compliance with respect to futures based upon movie box office receipts.

Finally, it is critical to note that today on Intrade, you can place trades on opening weekend box office results. The market is offshore, open to the public, unregulated and employs leverage. The greatest participants on Intrade are U.S. citizens.

The unintended consequences of the objector's efforts is likely to result in continuing to push market participants to retail, leveraged markets that are subject to no oversight by CFTC or Congress. Rather than push market participants offshore, MDEX seeks to list and clear contracts in a fully regulated and transparent

fashion subject to comprehensive CFTC oversight and sound risk management principles.

MDEX thanks the Committee for the opportunity to participate in this hearing and answer any questions regarding a proposed product of the MDEX DCM.

[The prepared statement of Mr. Swagger follows:]

PREPARED STATEMENT OF ROBERT S. SWAGGER, CHAIRMAN AND CEO, MEDIA DERIVATIVES, INC., SCOTTSDALE, AZ

I am Robert S. Swagger, Chairman and Chief Executive Officer of Media Derivatives, Inc., or "MDEX."

Thank you, Chairman Boswell and Ranking Member Moran for inviting us to testify today. You have asked us to discuss our application to list futures and options contracts based upon movie box office revenues. We are pleased to offer our views on these important matters.

I. Introduction

MDEX was founded three years ago for the purpose of creating risk management tools for the entertainment industry. MDEX is a small, privately-funded entrepreneurial business that is seeking innovative ways to manage risk, while attempting to create jobs in markets including Illinois, Indiana, Arizona and California, where our offices are located. One such risk management tool that we have developed, based upon market research and feedback, is that of regulated futures contracts based upon movie box office revenues.

MDEX has developed such a tool not in an effort to impose a risk management process upon the entertainment industry, but in response to a demonstrable need for producers, distributors, financiers and others to hedge the enormous and rising costs—and thus risk—associated with producing, marketing and distributing a major motion picture. Given that a single motion picture can cost more than $100 million to produce, the movie industry would appear to be an especially viable candidate for risk management tools. We have taken extreme care to design these products to ensure fair and equitable trading of the contracts and the integrity of the final settlement process. MDEX also looks forward to the opportunity to offer other risk management contracts for the entertainment industry, which may relate to revenues associated with, for example, music, video games and books.

We believe that the development of such products is consistent with a major thrust of Congress' enactment of the Commodity Futures Modernization Act of 2000, which sought to promote, among other things, innovation with respect to risk management tools such as futures contracts. The MDEX proposed products would encourage a transparent market place to establish increased liquidity for future financing of major films and other entertainment media.

II. Submission of Applications and Comment Periods; Bifurcation of DCM and Product Applications

On September 25, 2009, MDEX filed its application to become designated as a fully-regulated contract market, or "DCM." As a courtesy and in an effort to be proactive, MDEX submitted a draft application to CFTC staff as early as May 18, 2009.

Shortly after the formal submission of its application, the CFTC published the application for comment in the *Federal Register* on October 6, 2009 and the comment period remained open through November 5, 2009.

Over the course of the past 11 months, MDEX worked closely with CFTC staff to ensure that its products satisfy the statutory requirements of the Commodity Exchange Act (the "CEA"), including the eight Designation Criteria set forth in CEA Section 5(b) and the 18 Core Principles set forth in CEA Section 5(d). MDEX has also submitted, as part of and in support of its application, more than 100 documents, including a statement of compliance with the CEA, its rules, a Trading Facility and Disaster Recovery Plan, an agreement with the National Futures Association relating to the exchange's disciplinary program, an agreement with Minneapolis Grain Exchange ("MGEX") relating to the clearing of the exchange's trades, a comprehensive regulatory chart, and many other documents requested by CFTC staff. MDEX commends the CFTC and CFTC staff for their tireless and thorough efforts, and we are pleased to say that, after an extraordinarily comprehensive review, CFTC staff recommended to the CFTC that MDEX's DCM application be approved, and the CFTC approved MDEX's DCM application on April 16, 2010.

Additionally, in a separate filing on March 4, 2010, MDEX requested the CFTC to approve an MDEX futures contract based upon Opening Weekend Box Office Motion Picture Revenues. Importantly, MDEX did *not* self-certify the product listing. Rather, MDEX requested CFTC approval following publication and an opportunity to comment in the *Federal Register*. MDEX's product application remains under review by the CFTC, and we are working closely with CFTC staff to ensure that any concerns are adequately addressed.

On the eve of the expiration of the CFTC's 180 day review period—and more than four months after the close of the comment period for the DCM application—the MPAA and several other entertainment industry associations (the "Objectors") filed various general objections to the DCM and product applications and the notion of derivatives in the entertainment industry. Critically, if MDEX had learned of the Objectors' concerns four months ago, MDEX likely would not be testifying here today consuming additional taxpayer funds, as well as much-needed funds of a small business such as MDEX.

Most of the objections are the same objections that Congress, and this Subcommittee in particular, has heard for decades, such as futures contracts are a form of "legalized gambling." Other product-based objections may be more relevant, but nonetheless are misplaced or have been addressed with CFTC staff, as MDEX will detail below.

Notably, the Objectors sought not only to challenge the product listing, but also the DCM application. We strongly believed, however—and we are pleased that the CFTC agreed—that a DCM application should be viewed separately from any product application. To the extent that the Objectors have concerns about the products, such concerns should not have been levied in an effort to compel the CFTC to withhold its approval of the DCM application—especially when the comments arrived more than four months after the close of the comment period. We raise these concerns because we believe that Congress is and should be concerned equally about the process as well as the merits. From a credibility and fairness perspective, matters of procedure need to be honored if results are to be meaningful.

III. MDEX Seeks to Offer a Regulated, Transparent Risk Management Tool to the Entertainment Industry

The Objectors have declared that "the reputation and integrity of our industry could be tarnished by allowing trading in the movie futures contracts in a manner which allows them to be viewed as the economic equivalent of legalized gambling on movie receipts." [1]

Nothing could be farther from the truth, and MDEX has no interest in disparaging the reputation and integrity of Hollywood. Notably, the Objectors' broad and populist statement could apply to every industry that has a product upon which a futures contract is listed. It could apply, for example, to the U.S. Government and the listing of Treasury futures; the housing industry and the listing of housing futures; the insurance industry and the listing of weather futures; the listing of aluminum futures and the aluminum industry; and the agricultural industry and the listing of corn, wheat, soybean and other futures. The notion that regulated futures contract tarnishes an industry and is tantamount to "legalized gambling" is not only outdated, but parochial and baseless.

In fact, as witnessed during the financial market turmoil of 2007–2008, there is broad consensus that the futures markets not only performed admirably, but that futures contracts in no way contributed to the financial market turmoil. If anything, the consensus is that futures contract should serve as a *more prominent* risk management tool. Importantly, the Administration and many Members of Congress have proposed to require that standardized over-the-counter ("OTC") derivative contracts be executed and/or cleared on an entity regulated by the CFTC.

To be clear, MDEX is not seeking to establish a market for the trading of motion picture products in an opaque OTC market. Such a fragmented market already exists, albeit in a nascent form. In this market, participants bilaterally enter into hedges using OTC options. These transactions are unknown to other market participants, regulators or Congress. Rather, MDEX seeks to bring the demonstrable benefits of futures contracts—such as pricing transparency, liquidity and centralized clearing in a regulated environment—to the highly uncertain and variable outcome of movie box office revenues.

As discussed more fully below, MDEX believes, based upon its market research that the need for such a risk management tool exists. The function of hedging or, more broadly, risk management, is a fundamental underpinning of the derivatives markets and is weaved into the fabric of the CEA. The legislative history of the

[1] Letter from Objectors to Chairman Gary Gensler, CFTC, dated March 23, 2010.

CEA and its predecessor statute, the Grain Futures Act of 1922, is replete not only with references to the *commercial* importance of trading commodity futures, but that commercial parties should be able to look to properly functioning commodity futures markets for market information and products that facilitate marketing, financing and distribution decisions.[2]

Moreover, as a risk management tool, the economic efficacy of futures contracts, despite the recent financial market turmoil, remains beyond reproach. While futures contracts may involve risk—and particular types of derivatives and trading strategies may involve substantial risk—there is little doubt that derivatives *can* be used to perform critical hedging functions.

MDEX sought to become a DCM to bring the benefits of futures contracts to the entertainment industry. In seeking to promote price transparency, liquidity and hedging opportunities, MDEX also seeks to ensure the protection of customer funds. In this respect, MDEX plans to use an intermediation model of transaction execution in which all customer trades are executed by CFTC-registered futures commission merchants ("FCMs") and all customer funds are maintained in segregated accounts. Further, all transactions executed on MDEX will be cleared through a CFTC-registered designated clearing organization, the Minneapolis Grain Exchange.[3]

A transparent marketplace that allows institutional/professional traders to share in the substantial financial risks assumed by various participants in film financing would by no means cause harm to the integrity of the industry. Furthermore, there would be no increased costs for those Objectors who would choose not to participate in the exchange. Those studios that elect to participate in our markets will of course be subject to MDEX rules, including importantly, rules to assure that trading in our markets is fair and equitable. The costs a studio may incur to comply with exchange rules will likely be more than offset the financial benefits of prudent risk management using MDEX products. Markets in innovative new products should not be prevented due to unfounded fear and misunderstanding.

IV. Futures Contracts on Intangible Commodities are Permissible and Already Exist

Based upon the Objector's comments, there appears to be confusion as to whether the interests underlying MDEX's proposed contracts constitute a commodity on which a DCM may list contracts for trading.

At the outset, it should be noted that the definition of "commodity" in CEA § 1a(4) covers "services, rights, and interests" in which futures contracts are or may be dealt. That broad definition covers the reported cumulative gross box office revenues for a movie through its opening weekend that would underlie MDEX's Opening Weekend Motion Picture Revenue Contracts. Although futures contracts are often linked to an underlying cash commodity market, there is no requirement that a cash market must exist, and the absence of an underlying cash market for the our opening weekend box office revenue contracts is not grounds to disqualify them from trading. To the contrary, the definition of "excluded commodity" in CEA § 1a(13), which was added in 2000, expressly recognizes that a measure of economic or commercial return or value such as that underlying the opening weekend contracts is a permissible excluded commodity *if it is based on one or more commodities that have no cash market.*

Intangible commodities have been based on a broad array of outcomes and contingencies. Today, for example, the CFTC regulated market of the North American Derivatives Exchange lists binary contracts based upon many and diverse economic events. Moreover, the U.S. Futures Exchange ("USFE"), as a DCM, listed binary event contracts regarding whether the CME would buy the CBOT; another contract regarded whether the InterContinental Exchange would buy the CBOT. Notably, in listing these contracts, the USFE "self-certified" that the contracts comply with the CEA, and CFTC staff did not take any action to abrogate the listing of the contracts.

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[2] Grain Futures Act, ch. 369, 42 Stat. 998 (Sept. 21, 1922). *See also,* 73 *Fed. Reg.* 25669, 26672 (May 7, 2008); S. Rep. No. 93–1131, at 12 (1974).

[3] As part of its regulatory responsibilities, the CFTC monitors FCMs and clearing organizations with respect to the financial integrity of the commodity futures and options markets.[3] For example, CEA Section 4f(b) and the CFTC's financial and related record-keeping and reporting rules, such as CFTC Rules 1.20–1.30, 1.32, 1.36 and 1.49, are part of a system of financial safeguards that includes exchange and clearinghouse risk management and financial surveillance systems, exchange and clearinghouse rules and policies on clearing and settlements, and financial and operational controls and risk management employed by market intermediaries themselves. Two primary financial safeguards under the CEA include the requirement that FCMs segregate from their own assets all money and property belonging to their customers and the imposition of minimum capital requirements for FCMs and IBs.

Other exchanges have listed similar contracts, such as total insurance claims filed for hurricane damage.

V. MDEX's Proposed Contracts Serve an Important Economic Purpose

The contracts that MDEX seeks to list are not dissimilar to other futures and options contracts and, based upon MDEX's research with interested segments of the industry, portend to serve an important economic purpose in allowing parties with financial interests in the movie production and revenue chain to hedge the risks associated with producing a major motion picture. There is a broad group of potential participants with exposure to a film that are natural shorts, or even natural long hedgers, including:

- Original screenplay owners;
- Debt and equity investors;
- Investment banks syndicating a financing slate;
- Talent involved in the film;
- Studios;
- Banks and lenders;
- Insurers of talent and movies;
- Theaters;
- Distributors; and
- Co-promotional marketing partners whose results are inherently tied to success at the box office.

In addition, a host of other businesses stand to be impacted by the performance of movies and thus may have a legitimate need for such risk management tools.

Traditionally, the entertainment industry has found ways to hedge the risk associated with delay or cost overruns in the production and delivery of film product, some more efficient than others, through so-called "completion bonds," and negative insurance. However, there have been very limited means to minimize and manage performance risk.

Just as entertainment entities, like many businesses, have used foreign exchange and interest rate hedging to limit potential risks, the products to be offered by MDEX will provide a viable means of broadening the financial tools available to a very significant segment of the economy in an efficient and tested model. It is hard to imagine that the corporate parents of the studios do not have a keen interest in limiting the potential significant downside risk of a poorly performing picture. To spend $500,000 to create the floor for loss on a picture that is spending $65,000,000 in prints and advertising seems like a very reasonable business judgment.

With respect to those who are involved in the financing of films, the box office future contract would provide senior debt lenders with a tool to hedge the potential under-performance of films. In today's financial climate, lenders are likely to be unwilling to take box office performance risk even on a large portfolio of films if tools exist to aid them. Traditionally, this has been performed through so-called slate financings, a tool that has been severely limited by the current financial climate.

The availability of risk management contracts can provide a level of confidence and free-up financing capacity. For instance, the opening weekend box office product would provide to these parties a tool to hedge performance of future films in the slate financing should the performance of the initial releases be at a level that is lower than anticipated in the financier's underwriting criteria. This would reduce the overall volatility of the slate and would encourage lenders to once again be lending. As lenders provide debt to film slate financing, it should improve equity returns and thereby encourage equity investors to enter the market. Additionally, equity investors would not only have the opportunity to hedge their positions in the way similar to that used by the senior debt investors, but they would also have the opportunity to improve their returns by "going long" on their film slate thereby boosting overall returns and attracting additional capital to what is currently a capital starved entity.

VI. MDEX's Futures Contracts Do Not Promote Excessive Speculation and Do Not Rely Upon Leverage

Over the past few years, much has been written about excessive speculation, and the Objectors have joined the general choir. In designing its product, however, MDEX has worked closely with CFTC staff to reduce—if not eliminate—the likelihood of excessive speculation and the retail use of its products.

MDEX has created contract specifications that minimize such potential outcomes by specifying a relatively high notional value coupled with a requirement that each

contract be fully funded, or fully margined. In other words, there is *no* leverage component. MDEX's contracts thus do not avail themselves to speculation. At the same time, because they are fully margined and centrally-cleared by a CFTC-regulated clearing house, there is no credit risk. In all material respects, MDEX's contracts obviate risk; they do not create it.

VII. MDEX's Futures Contracts Are Not Susceptible to Manipulation

The Objectors have raised a concern regarding possible insider influence on compiling the public box office figures in order to affect final settlement prices for MDEX products, as well as possible actions that a film studio or distributor might take on the use of a movie's advertising budget to influence daily pricing of the contracts.[4] These concerns are relevant, but MDEX has addressed them through its product design, processes and procedures.

Clearly, a fundamental purpose of the CEA is to prevent manipulations in the commodity futures and futures options markets.[5] With respect to exchanges, this purpose is embodied in CEA Section 5(b)(2), Designation Criterion 2, which provides that the board of trade:

> shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.[6]

Further, CEA Section 5(d)(3), Core Principle 3, provides that the board of trade "shall list on the contract market only contracts that are not readily susceptible to manipulation."[7] In approving MDEX's DCM application, the CFTC has declared that both MDEX and the CFTC have the expertise and resources necessary to conduct market surveillance with respect to the commodities upon which MDEX seeks to list futures contracts. In working with the CFTC over the past 11 months, MDEX has taken the steps necessary to ensure that its opening weekend contracts will not be readily susceptible to manipulation. MDEX has satisfied these concerns through product design and various processes and procedures.

With respect to product design, MDEX's proposed opening weekend box office products are short-term contracts that are only listed for trading four weeks in advance of a movie's release. Four weeks prior to a movie's release, the market has a significant amount of public information at its disposal to render trading decisions, and marketing plans are well into the execution phase. Theater screens are set for the showing of the movie and only minimally adjusted in the final weeks prior to opening. Movie theater screens are finite real estate, and with the competition among movies at any given point in time, large numbers of screens are simply not available for a last minute changes. Importantly, MDEX rules require that the opening weekend revenue products cease trading *prior to a movie's release in theaters.* This serves to remove the concern regarding the earlier availability of box office information to the studio/distributor than the public.

Further, a key aspect of product integrity addressed by the CFTC and MDEX is the determination of the box office revenue figure used in establishing the products' expiration prices. In meetings that MDEX has held with major studios, it has been expressed to us that the studios are very sensitive to public expectations for box office revenues accuracy and reliability. In support of this studio position, MDEX presented information and developed rules and processes to ensure the integrity of its expiration prices. In particular, MDEX has developed a "Motion Revenue Contracts Box Office Revenues Validation and Verification Processes," which includes:

- Ensuring that the studio/distributor's publicly reported box office number fits within a pre-set standard deviation derived from data provided by the industry leading data provider—Rentrak—that collects box office revenue information directly from the theaters;
- Maintaining up to date studio/distributor and Rentrak data for all wide-release movies and using the data to periodically adjust the standard deviation;
- Requiring the studio/distributor to provide evidence to support its public box office number when it falls outside the standard deviation level;
- Requiring MDEX to determine an appropriate box office level, using Rentrak and studio/distributor data, in which to establish the final expiration prices, when the studio/distributor cannot justify its box office number; and

[4] *See* Letter from Objectors to Chairman Gary Gensler, CFTC, dated March 23, 2010.
[5] *See* CEA §§ 3(b) and 9(a)(2).
[6] CEA § 5(b)(2), 7 U.S.C. § 7(b)(2).
[7] CEA § 5(d)(3), 7 U.S.C. § 7(d)(3).

- Weekly verification of the Rentrak process for collecting theater box office data.

In addition, MDEX has adopted a series of Firewall and Restricted Participant Review protocols to prevent the improper use of information. Under the protocols:

- Communication is prohibited between the individuals responsible for or having input into the studio/distributor's decisions to trade such Contracts (the "trading group"), on the one hand, and its employees who are responsible for compiling and/or computing the gross box office revenues publicly disseminated by such studio/distributor for its motion pictures regarding the studio/distributor's positions in any such contracts or the trading group's decisions or discussions with respect to establishment of such positions. The disclosure prohibition on these employees also extends to disclosing the information to any other parties, except as necessary, in performance of the employee's responsibilities.
- Certain employees within a studio/distributor and companies that collect box office revenues are prohibited from trading MDEX box office products.
- Studios/distributors that participate in MDEX markets are required to adopt procedures to monitor the communications and enforce the trading prohibitions.
- MDEX will periodically review the studio/distributor procedures and require them to attest that the procedures are included in internal control reviews.
- MDEX will routinely review a studio's/distributor's expired movie contracts for patterns between expiration prices and positions to determine if there may be issues with firewall procedures.
- When a party applies to the exchange for trading access, MDEX will require the party and his clearing firm to identify whether he may be subject to trading restrictions under the MDEX rules.

All of the foregoing procedures and processes have been painstakingly addressed and examined by CFTC staff. The staff, in recommending the approval of our application, understands and agrees with the efficacy of the procedures and processes.

Moreover, from the perspective of investor protection, the CEA also strictly prohibits actual and attempted manipulations by market participants. The prohibitions against manipulation of prices are set forth in CEA Sections 6(c), 6(d) and 9(a)(2).[8]

Notably, the CEA does *not* prohibit insider trading by market participants in the commodity futures and options markets, based upon the premise that barring insider trading would defeat the market's basic economic function of allowing traders to hedge the risks of their commercial enterprises.[9] In other words, virtually every commercial hedger has some amount of inside information.

VIII. Contracts Based Upon Movie Box Office Currently Trade on Unregulated Foreign Markets

Finally, it is critical to note that, as we speak, unregulated foreign markets trade products based upon movie box office revenues and related measures. For example, on Intrade, a market based in Ireland, you can place trades on the opening weekend box office results of *Iron Man 2* or *Date Night.* This market is open to the public,

[8] 7 U.S.C. 9, 13b, and 13(a)(2). CEA Sections 6(c) and 6(d) authorize the CFTC to issue a complaint if it "has reason to believe that any person . . . is manipulating or attempting to manipulate or has manipulated or attempted to manipulate the market price of any commodity, in interstate commerce, or for future delivery on or subject to the rules of any registered entity." 7 U.S.C. §§ 9, 13b. CEA Section 9(a)(2) makes it is unlawful for "[a]ny person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any contract market, or to corner or attempt to corner any such commodity." 7 U.S.C. § 13(a)(2) (2002). Together, CEA Sections 6(c), 6(d), and 9(a)(2) prohibit both manipulation and attempted manipulation.

[9] *See, e.g.,* Testimony of Commission Chairman Phillip McBride before the *SEC/CFTC Jurisdictional Issues and Oversight: Hearings on H.R. 5447, H.R. 5515 and H.R. 6156* Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, 97th Cong., 2nd Sess, Part 1 at 21 (1982); *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material Non-Public Information* (Sept. 1986). Trading on material non-public information is prohibited under the CEA, but only with respect to three general categories of persons. First, the statute prohibits CFTC Commissioners, employees and agents from trading on non-public information. CEA § 9(a)(4), 7 U.S.C. § 13(a)(4). The statute similarly prohibits CFTC Commissioners and CFTC employees from delivering nonpublic information to third parties with the intent to assist them in conducting trades; the CEA also forbids individuals who receive this information from trading on it. CEA § 9(d), 7 U.S.C. § 13(d). Finally, the CEA prohibits employees and board and committee members of a board of trade, registered entity, or registered futures association, from willfully and knowingly trading for their own or on behalf of any other account, futures or options contracts on the basis of any material non-public information obtained through special access related to the performance of their duties. CEA § 9(e), 7 U.S.C. § 13(e).

unregulated and employs leverage. The unintended consequence of the Objectors' efforts is likely to result in continuing to push market participants to retail, leveraged markets that are subject to no oversight by the CFTC or Congress.

Rather than push market participants offshore, MDEX seeks to list and clear contracts in a fully regulated and transparent fashion, subject to comprehensive CFTC oversight and sound risk management principles.

IX. Conclusion

MDEX has allocated substantial efforts and resources to develop its DCM and entertainment risk management products. MDEX recognizes—as many within the entertainment industry recognize—the unique and growing risk management challenges facing the entertainment industry. MDEX looks forward to the opportunity to allow market participants in the entertainment industry to determine whether MDEX's proposed product is suitable as a risk management tool.

Media Derivatives, Inc. thanks the Committee for the opportunity to participate in this hearing and answer any questions regarding a proposed product of the MDEX DCM.

The CHAIRMAN. Thank you.

The chair would now like to recognize Mr. Pisano, president and interim Chief Executive Officer for Motion Picture Association of America.

STATEMENT OF A. ROBERT PISANO, PRESIDENT AND INTERIM CEO, MOTION PICTURE ASSOCIATION OF AMERICA, INC., WASHINGTON, D.C.

Mr. PISANO. Thank you, Mr. Chairman, Mr. Moran, and Members of the Committee. Thank you very much for allowing us to be here today.

I am appearing today on behalf of the six companies that are represented by the Motion Picture Association, but also on behalf of a really unprecedented coalition of members of the industry who are traditionally, frankly, warring parties. You have present at this table representatives of labor and management, representatives of exhibition and distribution, and representatives of large studios and small independent producers. To envision all of these groups together on a single issue is almost unimaginable, but it is this issue that has brought us together.

The second thing I would like to say is I come before you as a representative of a trade association, but also as someone who has actually spent 25 years in the movie industry. I have been an executive at Paramount, MGM, I was head of the Screen Actors Guild. And in the course of my career in the industry, I have probably been associated with the production, financing, distribution and marketing of well over 200 films. And so I come at this from the standpoint of someone who has actually been in the industry and is deeply concerned about it.

We have a way of marketing movies in the industry in which we say, "From the producer up," or, "The director up," and I am tempted to say this movie, this particular movie, this particular idea, should be marketed as from the producers who brought you the derivative debacle, and I don't mean that all derivatives are bad. What I do mean is this derivative falls in that category of synthetic, fictional instruments designed solely for speculation or gambling.

My first point, and Congressman Goodlatte made it earlier, there is no market for movie box office receipts. In fact, movie box office receipts reporting were created by my company in the 1980s as a

way of marketing our movies. We wanted to be able to say that we had the number one movie of the weekend. You can't buy them; you can't sell them; and equally important, you can't take delivery of them because nobody makes them available. They are simply an indication of public support.

Second, as Congressman Goodlatte also pointed out, this is a unique product. The functional equivalent of writing a commodities contract in a traditional way would be to write that contract on a cow or an ear of corn. And I dare say if such a contract came before the CME, it would be excluded.

So you have these two factors: No market, no buying and selling; a unique product, and to me that gives you the potential for manipulation because the very people who are buying and selling it are people who are not part of the industry, have no stake in it, and are only speculating. So that, in turn, raises the possibility of harm to the industry because a short position against a movie reported on an exchange with an aura of authenticity will become a self-fulfilling prophecy. People will stay away from the box office because the price of the movie in the futures market has gone down. I submit to you that is both subject to manipulation; and, frankly, it is subject to hurting both the industry and the individual movie.

I can speak about the injury to the industry, and my colleague, Mr. Harbinson, will speak about the harm to the creators, the people who actually create the movie, the directors, the writers, the actors. They work on one movie, and to have that subject to speculation and arbitrary trading in order to affect the outcome is something that should not be permitted.

So we have no price, no market, a unique product, subject to manipulation, subject to harm. What do we have here? I submit to you we have wager, gambling over and under betting. That is something that more properly belongs in Las Vegas, no offense to Las Vegas, and regulated by the gambling laws. It should not be put in the clothing of a commodity.

And so we urge the Committee to urge the CFTC to deny the applications for the contracts and we urge the Committee at conference to support the amendment in the Senate financial reform bill prohibiting trading in these kinds of agreements.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Pisano follows:]

Prepared Statement of A. Robert Pisano, President and Interim CEO, Motion Picture Association of America, Inc., Washington, D.C.

Thank you, Chairman Boswell and Ranking Member Moran, for the invitation to provide testimony before the Subcommittee on General Farm Commodities and Risk Management of the House Committee on Agriculture, regarding proposals to designate contract markets that will provide a mechanism for trading futures and option contracts in motion picture box office numbers. My name is Robert Pisano. I am appearing today and providing oral testimony on behalf of the Motion Picture Association of America, Inc. ("MPAA"). However, these prepared remarks are submitted as the collective views of The Directors Guild of America, Inc. ("DGA"), the Independent Film & Television Alliance ("IFTA"), the International Alliance of Theatrical Stage Employees ("IATSE"), and the National Association of Theatre Owners ("NATO"), as well as the MPAA and its member companies, Paramount Pictures Corporation, Sony Pictures Entertainment Inc., Twentieth Century Fox Film Corporation, Universal City Studios LLLP, Walt Disney Studios Motion Pictures, and Warner Bros. Entertainment Inc., which represent perspectives from all corners of the motion picture industry.

I have spent virtually my entire career in the film business, first as a partner of a major law firm working on entertainment matters before joining Paramount Pictures as executive vice president and general counsel in 1985. At Paramount, I was responsible for all legal and legislative affairs, as well as labor relations and business development. I was a member of the Office of the Chairman and the Operating Committees of the studios' international theatrical, video, and pay television distribution and exhibition joint ventures. I left Paramount and joined Metro-Goldwyn-Mayer in 1993 as Executive Vice President and then became Vice Chairman, when I had the responsibilities of chief operating officer. Immediately before joining MPAA, I was National Executive Director and CEO of the Screen Actors Guild. My views, my opposition to futures trading in box office receipts, reflect not only the views of the MPAA and its members, and the film industry coalition allied with MPAA on this matter, but also my long experience engaged in the financial and business aspect of the film industry.

The Commodity Futures Trading Commission ("CFTC") currently has before it applications to approve or deny two proposed commodity futures contracts and a commodity option contract that are designed to allow the contracts' users to bet on the level of gross motion picture box office numbers for single and unique motion pictures ("the proposed contracts" or "the contracts"). We strongly oppose approval of these proposed contracts because they are nothing more than gambling contracts that lack any of the characteristics of legitimate futures contracts, fail to serve any public interest, and will harm all parts of the motion picture industry. Descriptions of the terms of the proposed contracts are included in *Attachment A* to these remarks.

Legitimate commodity futures contracts invariably are designed to serve the interests of the industries that use the underlying commodities by providing a means to discover prices and hedge commodity price risks. Consistent with this, Congress has declared in Section 3(a) of the Commodity Exchange Act ("CEA"), 7 U.S.C. § 5(a), that transactions covered by the CEA "are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating price information." CEA Section 3(b), 7 U.S.C. § 5(b), further declares that it is the "purpose of this Act to serve the public interests described in subsection (a) . . . ." It is service of these public interests that distinguishes legitimate, lawful futures contracts from gambling contracts that are either proscribed as crimes by the Federal Wire Act or regulated by state gaming authorities.

The proposed contracts, which are sponsored by Media Derivatives, Inc. ("MDEX") and The Cantor Futures Exchange L.P. ("Cantor"), serve no public interest and, to the contrary, can significantly harm the motion picture industry and impose new, substantial costs that do not exist today. A Cantor affiliate currently operates a website known as The Hollywood Exchange that lets users of the site engage in make-believe, non-monetary bets on the success of particular motion pictures. The request for CFTC approval of the proposed futures contracts is a transparent device to convert such make-believe, online betting into a for-profit wagering service, thereby circumventing the criminal proscriptions of the Federal Wire Act.

The CEA, however, does not authorize the CFTC to license gambling contracts that fail to serve the public interests required for every lawful futures contract. And, in light of the existing significant strains on the CFTC's scarce resources in regulating legitimate futures and derivatives markets, those resources should not be diverted now to policing gambling on motion picture box office numbers.

A. The Proposed Contracts Provide No Price Discovery or Hedging Service to the Motion Picture Industry; They Are Simply Betting Instruments

The motion picture industry is distinctly different from industries that have use for legitimate futures contracts. First, in the motion picture industry, there is no cash market in any "commodity"—no articles or interests are traded among buyers and sellers for which a futures market is needed or desirable for price discovery.[1]

[1] Motion picture box office numbers are outside of the legal definition of a "commodity" under the CEA because (a) no rights or interests are traded in motion picture box office numbers, (b) such numbers (as announced by *Variety*) do not value any other traded article, good, right or interest, and (c) such numbers are not beyond the control of certain industry insiders. All of the commodities specifically enumerated in CEA Section 1a(4), 7 U.S.C. § 1a(4), are traded in cash markets, and the requirement that futures prices reflect the legitimate forces of supply and demand of an underlying cash market further requires that futures contracts be permitted only to the extent that they reflect the valuation of articles, rights and interests that are traded. In addition, box office numbers are not within the CEA's definition of "excluded commodity" because they are within the control of or, at a minimum, highly influenced by, a small group of entities (*i.e.,* producers, distributors and exhibitors) that control, among other things, the num-

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Second, the product of the industry is an artistic or entertainment product that derives its value not from any intrinsic utilitarian use, but from emotional sentiment. Whether a motion picture will connect with an audience has proven quite difficult to predict, and in some instances sentiment for a motion picture can prove to be quite fleeting. There is no set formula for success, which depends on the totality of such things as artistic intangibles, marketing, release date, opening locations, and the national mood, fears, and fascinations at a particular time. Significantly, studios must invest virtually all of their capital up front. Accordingly, post-production, studios have natural incentives to avoid any action that can threaten an audience's interest in or reception of a motion picture.

Third, unlike most other products that are the subject of futures contracts, the value of an individual motion picture is not priced in open bidding among a large contingent of interested parties. Rather, a relatively small number of entities (the studio, the exhibitors, and marketers) have inordinate impact on the potential for box office numbers in the opening weekend and beyond for any particular motion picture. Their private decisions as to release dates, opening locations, number of theaters, number of screens, size of screens, and marketing budgets can significantly impact box office numbers in the early weeks of showings. Those decisions can be in flux up to the opening release and beyond, and much of the information regarding those decisions is closely held and protected from public dissemination. Fourth, unlike all other industries that use futures contracts, the motion picture industry has no constituents that would be natural long hedgers—no one has a risk of loss if a motion picture is wildly successful. Accordingly, there is no natural price competition in any purported "market" for box office numbers.

Neither of the sponsors contends that their proposed contracts offer any price discovery function. Studios receive information on box office numbers directly from exhibitors and others, including Rentrak Theatrical ("Rentrak"), a private company that compiles information on box office numbers from many, but not all, exhibitors. The public generally receives estimates of gross box office numbers from reading stories in the general press based on figures announced by the studios and Rentrak.

Moreover, the bets made on the proposed contracts would not be a reliable indicator of box office numbers, because much of the material information affecting such numbers is non-public. Bettors would not have access at any time to much of the material information affecting a motion picture's box office performance (*e.g.,* marketing budgets, distribution agreements), because it generally is not publicly available. Trying to forecast box office numbers prior to a motion picture's release without the benefit of the non-public information that is closely held by studios and other motion picture industry insiders is arbitrary.[2] Significantly, none of the means used to assess the legitimacy of futures pricing based on supply and demand would exist for the proposed contracts. Prior to the publication of estimates of box office numbers for the first weekend release, there is no cash market pricing, no additional months of futures market pricing, and no actual cash market transactions against which to measure the legitimacy of the futures price.

Further, non-public business decisions regarding motion picture marketing and distribution plans that affect box office numbers can and do occur up to and throughout the release of the motion picture, with studios constantly adjusting their distribution patterns and marketing spend to take account of consumer acceptance of a film. Although a preliminary plan is prepared in advance of approving a motion picture for production (*i.e.,* well before a release date is scheduled), the plan remains subject to change and in fact is continually adjusted until the motion picture is released and beyond. Marketing changes generally can be made within a day and in some cases almost immediately, in terms of changing marketing materials, their placement, or their relative frequency of use.[3]

The proposed contracts have no appeal or use with respect to the public interest criterion of hedging. Studios mitigate their financial risk at the pre-production stage or early in the production stage by a host of techniques, including partnering with

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ber and location of theaters in which a motion picture is shown, the number of screens and size of screens on which a motion picture is shown, and the marketing budgets for a motion picture. *See* CEA Section 1a(13)(iv)(I), 7 U.S.C. § 1a(13)(iv)(I).

[2] Marketing and distribution plans are never made public. Prior to release, traders could see trailers, TV spots, and print, online, and outdoor advertisements. However, the marketing spend itself and the break-down of spend by media are not public and would be difficult to determine as an outside observer, particularly as marketing varies by location.

[3] The press does report the number of screens on which a motion picture will be released (but usually only within a week of release) and may report changes in screen count earlier if it becomes known that the scope of release has been significantly increased or decreased for a motion picture, but this information alone, without knowledge of other material, non-public information, is wholly inadequate to reasonably predict box office numbers.

other companies to share the risk, diversifying projects across different segments of the viewing audience, selling downstream rights early to cover costs, and raising capital in private and public markets to effectively syndicate the risks. Studios further mitigate their financial risk by balancing their slate of motion pictures with a variety of types of pictures (new films and remakes; low budget and high budget; teen and adult; comedy and drama and horror, *etc.*).

Although it may appear in theory that establishing a short position in a futures contract could be a "hedge" against poor box office performance, in the reality of the marketplace, selling a motion picture "short" after production would invite catastrophic collateral consequences, both for the particular film's success and future relationships with financiers, directors, actors, exhibitors and others. Commercial interests involved in a motion picture will not run the risk of negative publicity by creating even the potential for accusations or rumors that it was "betting against" the success of its own picture by "shorting" it in a futures market. Moreover, there is a legal concern that such shorting transactions could generate claims of violating standard mutual covenants in industry contracts with exhibitors, directors, actors and others that prohibit disparagement of the work.

For independent producers, whose films are often released in the U.S. by the major studios, which control marketing and release plans, mitigating financial risk may be even more difficult. Independent producers secure financing on a film-by-film basis with different investors for each film and rely heavily on the distribution commitments of foreign distributors before production of the film even begins. Those minimum commitments, along with any government incentive programs, are collateralized by financial institutions and other investors, which loan the producer the production budget. Independent producers rely on the proceeds of foreign distribution to pay back the production loan, and therefore any hedging by U.S. distributors could harm not only independent producers, but also the dozens of financial and commercial partnerships they must build worldwide to secure financing for each film.

Theater owners similarly have no incentive to bet against a motion picture. They do not want to be perceived as betting against the product they will be offering and they have other means to mitigate risk. By virtue of the Paramount Antitrust Consent Decrees entered into with most of the major motion picture studios about 60 years ago, the studios license on a theater-by-theater and picture-by-picture basis. Motion picture licenses are *not* tied one picture to another. Doing so would be a violation of the Paramount Antitrust Consent Decrees and, in any case, also would raise antitrust considerations. Therefore, *no exhibitor is obligated* to license *any* motion picture. If an exhibitor *chooses* to license a motion picture, the rental for that license is negotiated separately, and any concern that the exhibitor may have regarding the public's interest in the motion picture (*i.e.,* potential success) will be reflected by the percentage of the rental the theater owner agrees to pay based on those negotiations. Motion picture rental is paid as a *percentage* of the gross numbers of tickets sold.

Significantly, underscoring the fallacy that the proposed contracts are even close to being legitimate futures contracts, the sponsors' contract rules effectively and, for Cantor's contracts, expressly, prohibit trading by studios and other insiders, thus precluding any potential for hedging whatsoever.[4] These rules are unique among all futures contracts. They bear witness to the fact that the proposed contracts, unlike legitimate futures, do not in fact price "commodities" that are traded in a market, but, rather, are bets on the value *for a single product* (the motion picture), which can be substantially influenced through the actions of relatively few insiders. The sponsors' rules suggesting the use of an "Information Barrier" as a means to avoid the proscription of insider trading provide no assistance in permitting hedging. Such a barrier requires futures traders for a studio to be cordoned off from any information within the studio that would provide the basis for determining hedging needs and strategy. Studio and other industry insiders who have the ability to materially affect the level of box office numbers also likely would be wary of trading in the proposed contracts in any event, because doing so increases the potential of incur-

[4] Cantor's filing on April 14, 2010 with the CFTC of a proposed contract based upon "The Expendables" expressly prohibits any person in possession of material, non-public information from trading in the contract until the information has become public. Examples of such information cited in Cantor's rules include, but are not limited to, changes in release date or the promotion or advertising budgets, number of theaters showing the film, and actual box office receipt statistics following release. Cantor's rules purport to require studios and other entities to adopt policies to ensure that their officers, directors, employees, and agents, including authorized traders, do not trade on the basis of material, non-public information.

ring significant legal costs in having to respond to inquiries from governmental investigations and/or private claims if futures prices gyrate.

As a practical matter, any decisions by a studio to hedge any risk would need to be cleared with senior management, who necessarily have intimate knowledge of all financial and contractual information relating to a motion picture and under the sponsors' rules would not be permitted to interact with traders. In this connection, box office numbers data are very important and sensitive information that is shared within a studio with, among others, key mid-level marketing personnel, the General Counsel's Office, and senior management. No studio is arranged or intends to reorganize itself so as to separate the management and reporting lines of persons with access to the box office numbers data and the persons who compile or compute those figures. It makes no sense to do so and would prevent a studio from utilizing the box office numbers data in the most efficient manner.

B. The Proposed Contracts Will Harm the Motion Picture Industry

Currently, studio estimates of box office numbers do not impact anyone; they are of no consequence to the public's interests. However, the CFTC's approval of the proposed contracts will *create:* (a) burdens for motion picture financing by creating new, but unreliable and non-economic, prognostications of a motion picture's success, (b) conflicts of interest for studio employees and independent contractors by creating a means to bet against the success of motion pictures, and (c) new legal risks for studios in, among other things, announcing estimates of box office numbers and having to police the use of inside, non-public information affecting box office numbers that could be material to bettors' trading decisions.

The pricing on the proposed contracts creates a greater risk of depressed box office numbers because such pricing, although lacking any reliable economic basis, could harm a motion picture's prospects by negatively affecting financiers' and audiences' perception of it. Because the ultimate breadth of distribution can be revised up to the time of release and afterward, the proposed market could affect distributors' ability to secure screens if the pricing of contracts signals a sentiment of negative box office results. The harmful effect of negative publicity is not limited to theater showings. Many prices for downstream licenses and other sources of revenue are driven in part by actual box office receipts. Motion pictures slated to open in limited theaters (which can easily meet the threshold requirements of the proposed contracts of 600 theaters for MDEX and 650 for Cantor) and then broaden based on word of mouth could be ruined by futures pricing that casts them in the false light of a "failed" opening.

The impact of piracy could be amplified by these contracts because trading in the proposed contracts also creates a new means to try to profit from theft of studios' confidential motion picture materials, thereby increasing the likelihood of such theft and exacerbating our industry's existing widespread motion picture piracy problems. For example, a person who steals a motion picture or motion picture creative materials, in finished or unfinished form, before its release could short the contract and then post it on the Internet to hurt box office numbers. Similarly, a person armed with critical inside information might use it to profitably trade in the proposed contracts. Nothing in the sponsors' publicly available materials about their contracts begins to suggest how either will be able to detect and prevent such manipulative conduct. Given the rise of the Internet and other technologies, piracy and leaks of confidential information are growing threats to the motion picture industry. The CFTC should not provide any additional incentives for motion picture piracy and stealing intellectual property by approving the proposed contract applications.

Approval of the contracts also creates a whole host of new financial and legal costs and burdens that do not now exist. Once a contract is traded in box office numbers estimates, the announcement of such estimates has consequences for bettors. This, in turn, creates legal risk for studios in announcing their estimates—where none exists now—because mistakes that are currently meaningless could now be portrayed as impacting bettors' financial results from their contracts, thus giving rise to private claims for damages for negligence, misrepresentation, or even, given the minimal pleading requirements for commencing actions, manipulation. The cost of litigating even unmeritorious claims could be substantial and cause studios to cease or significantly alter the practice of public announcements.

Approval of the proposed contracts also will require studios and all other industry participants that have the power to affect futures pricing to institute and police anti-insider trading compliance regimes for the proposed contracts. It is problematic whether any prohibition on insider trading would need to take into account inside information held by persons who are not subject to the control of the studios. In the event that the studio is distributing an independent film, the potential for many more insiders outside of the studio's control is enormous. There are many industry

participants who have access to material, non-public information and could try to use that information to profitably bet on the proposed contracts. There are many insiders, for example, in studio marketing and distribution departments and upper management and in exhibitors' finance, marketing and contracting departments, who have access to such material, non-public information as actual box office data, internal forecasts, advertising strategies and spending, and release patterns.[5] Exhibitors also have a right to see a motion picture prior to licensing it in the U.S.[6]

Even if a studio's compliance system is designed and executed to perfection, it is possible that, at some point, the CFTC or the Department of Justice will investigate a suspicion of possible manipulation of the proposed contracts, causing large legal expenses for the industry. The studios would be put to great expense to comply with the investigation. Moreover, studios and other industry insiders would be natural targets for strike suits by disappointed traders. Further, the negative publicity that could flow from rumors or announcements of an investigation and from strike suits would be damaging to the industry parties involved. These are risks and costs that do not now exist and the industry will receive no benefits from the contracts to offset these substantial risks and costs.

These essential public interests reflect a legislative intent that futures contracts provide economic value beyond pure speculation. Consistent with this, the contract market designation criteria and core principles requiring that contracts not be readily susceptible to manipulation and that a designated contract market ("DCM") prevent manipulation are founded on the principle that futures contracts are tied to legitimate cash markets, serve an economic purpose for those markets, and that futures prices should reflect, in the CFTC's oft-used words, the "legitimate forces of supply and demand" in an underlying cash market. The Appendices to the CFTC's rules governing contract market designation specifically require, among other things, that a board of trade applying to be approved as a DCM shall submit a "description of the cash market on which the contract is based" and the "designated contract market should collect data in order to assess whether the market price is responding to the forces of supply and demand." Similarly, CEA Section 4(a), 7 U.S.C. § 6(a), expressly condemns "excessive speculation" and authorizes the CFTC to prohibit it.

These features of the CEA unambiguously demonstrate Congress's intent that, for futures contracts to be lawful, they must provide price discovery and hedging functions and not simply be an outlet for speculation. The Commodity Futures Modernization Act of 2000 may have relaxed the procedures for designating contract markets, but it did not extinguish or even change the statute's central requirement that regulated futures contracts meet those criteria.

The proposed contracts cannot serve these public interests. It is undisputed that they will not provide a means of price discovery; indeed, MDEX and Cantor do not even argue that their contracts serve this public interest. Nor, as discussed below, will the proposed contracts in fact be used for hedging. Rather, they are simply a means by which the sponsors of the contracts seek to serve their own private interests and the private interests of persons who would like yet another outlet for speculative pursuits. Such activity should not receive the sanction of the Federal Government or take up any of the government's scarce regulatory resources especially where, as here, the contracts would be harmful to the industry they purport to serve.

C. Reports of Box Office Numbers Are Not Free From Error

Box office estimates largely have been a marketing tool; they were not created to support financial trading. The practice in the motion picture industry is to report *estimates* of weekend gross box office numbers on Sunday, based on projections informed by numbers received for Friday and Saturday showings. *Variety* publishes

[5] Other insiders who could possess material, non-public information range from financiers and their advisors, potential distribution partners, talent, crew, agents and other representatives, special effects and other post-production vendors, trailer houses, festival screening committees and the employees, families, and friends of all these people. Insider trading also could implicate insider trading proscriptions of the Federal securities laws, where a movie's box office success could be material to the market value of its producer's publicly traded securities. Also, the rise or fall of an independent production company's release could have a material impact on its future ability to function; trading in such a picture's prospects could doom not only that picture, but future pictures and, in the worst case, the entire company. The proposed contracts thus could be used by insiders as surrogates for their companies' securities in order to profit from inside information.

[6] Although certain members of the public may see a motion picture prior to its theatrical release, and their reactions may become public through social media and social networking technologies, much of this information remains non-public.

those estimates on Monday, as do many major newspapers and media sources. Those estimates, which are generated by the studios, are based in part on non-public and undisclosed projections and assumptions that can vary from motion picture to motion picture and from studio to studio. *Variety* provides this disclaimer about the information it publishes:

> "*Variety* publishes data compiled by Rentrak Theatrical, which collects *studio reported data* as well as box-office figures from North American theatre locations. Any information provided by Rentrak has been obtained from sources believed to be reliable.
>
> However, Rentrak does not make any warranties as to the accuracy, completeness or adequacy of this information and data. The user of this data agrees Rentrak, its officers and employees will have no liability arising from the use or disclosure of this information and data. To submit any questions to Rentrak, please e-mail: *boxofficeinfo@rentrak.com.*"

See: http://www.variety.com/index.asp?layout=b_o_layout&dept=Film (emphasis added). Those estimates, as with estimates of all types, can be flawed, although traders rely on them—see the articles from *Variety* about errors in estimates of weekend box office numbers for the past two consecutive weekends in April 2010, which are attached hereto as *Attachments B* and *C*.

The box office receipt information Rentrak compiles from the exhibitors that have agreed to provide that information to Rentrak is itself incomplete, and we understand that the percentage of the total box office numbers that is reported by exhibitors to Rentrak can vary materially from motion picture to motion picture depending on how many exhibitors within its universe of reporting exhibitors are showing a particular motion picture. We understand that many exhibitors record box office numbers electronically and then provide the aggregate information to Rentrak through an electronic feed, but also that many exhibitors tabulate their numbers manually. However, *some exhibitors never report to Rentrak, either automatically or manually.*[7]

Typically, studios, upon receiving Rentrak exhibitor-based figures, in turn conduct their own information gathering and analysis to develop their estimates that may be publicly announced in the press. As *Variety*'s disclaimer indicates, the studios' Sunday announcements of weekend motion picture box office numbers information in *Variety* include the studios' estimates. The studios' information gathering and analysis may vary from one company to another and is closely held proprietary information, but it can include, for example, communicating with some of the exhibitors that are not included in the Rentrak figures and even those exhibitors that are included in the Rentrak figures if their information appears to be potentially inaccurate or incomplete.

Even the studios' box office estimates announced subsequent to the Sunday estimates are unaudited and never capture 100 percent of box office numbers. None of the data reported to *Variety*, the Rentrak compilations, or the studio estimates are used to settle transactions between exhibitors and distributors. Those transactions are settled by reporting of actual gross box office receipts between the contract parties, on a non-public basis, and subject to their contractual accounting and audit rights and obligations. In addition, it should be noted that neither Rentrak nor studio figures adjust for U.S./Canadian exchange rates. Further, studio-announced figures may include data reported to the studio by a third-party distributor where U.S. and Canadian theatrical rights are held by different entities.

D. The Proposed Contracts Are Susceptible to Manipulation and Price Distortions

In the first instance, the lack of any legitimate economic measure of valid pricing before the Rentrak numbers are announced prevents any ability to even identify a manipulated price. Further, the potential box office numbers for a single motion picture can be materially affected by individual industry participants in a variety of different ways that would be exceedingly difficult to detect. Exhibitors that contribute to the Rentrak numbers could, either intentionally or accidentally, misreport their data. A distributor could determine within the period following a motion picture's release to reduce or increase the number of theaters that would show the motion picture. A distributor for a variety of reasons could determine to substantially

[7] Our understanding is that not all exhibitors provide information to Rentrak and, therefore, the completeness of Rentrak's tabulations for any particular motion picture for any particular period, as measured against the entire universe of box office numbers for a motion picture for that period, can vary based upon the number of screens on which it is shown by exhibitors that provide their information to Rentrak.

reduce or expand its marketing budget, which can materially affect box office numbers. A major exhibitor could decide to show the motion picture on smaller or larger screens, which can materially affect audience interest and capacity. We respectfully submit that the sponsors have no effective means to detect or prevent such conduct or to determine whether it was undertaken for valid business reasons, rather than to manipulate futures prices.

Futures prices for individual motion pictures also are susceptible to manipulation by false market rumors. In the unique circumstances of the motion picture industry, it would be virtually impossible to identify the sources of such rumors or to prosecute any alleged manipulation by false rumors, because such rumors would typically be based on opinions relating to a motion picture's artistic or entertainment merit rather than verifiable facts. There already are plenty of rumor mills with respect to the quality of motion pictures and many of them are in the online environment. These range from reviews by members of the public who have attended screenings, professional reviewers, press reports relating to rumored or perceived "trouble" on motion pictures (multiple writers, talent defections, re-shoots, postponed release dates, *etc.*), and reports of the quality of footage that have leaked pre- or post-release. There is no effective way to police such rumors or reliably determine their source. These sorts of rumors can depress or increase box office performance. Therefore, the ability to profit from rumors by trading in the proposed contracts would intensify any incentive to spread false rumors in a manner that the sponsors could neither detect nor control.

I wish to thank once again Chairman Boswell and Ranking Member Moran for the invitation to provide testimony, and I will be happy to respond to questions from Members of the Subcommittee.

ATTACHMENT A

The Proposed Contracts' Terms

A. The Cantor Contracts

The Cantor contracts are complicated, and to some degree uncertain, trading instruments, and their material terms can vary from one motion picture title to another and even without notice to traders at the time trading commences.[8] Generally, however, the Cantor submission states that its contracts would provide a means to bet on gross domestic box office numbers of select motion pictures released in the United States and Canada, "as compiled by Rentrak Theatrical and/or Nielsen EDI and published in *Variety* Magazine (or such other publicly available source or sources *as may be designated* by the Exchange from time to time)."[9] This description is confusing because the information about gross box office numbers *as published by* ***Variety*** *Magazine* is not the same as the information "compiled by Rentrak" *from exhibitors.* (Rentrak's compilations from exhibitors do not account for 100% of gross box office numbers, and the percentage of the total box office numbers reflected in the figures it collects from exhibitors can materially vary from motion picture to motion picture.)

The Cantor submission states that each motion picture will be the subject of its own separate contract, and Cantor will decide in its discretion the motion pictures for which it will list futures contracts on its platform.[10] The Cantor contracts will call for traders to bet on the gross Domestic Box Office Receipts ("DBOR") over the "DBOR Determination Period." The DBOR Determination Period runs from the date of the motion picture's opening until 4 weeks after the motion picture first qualifies for "wide release" status as defined by the Cantor rules.[11] Those rules define "wide release" status to occur once a motion picture is shown simultaneously on the same

[8] *See* Cantor Rule I–1, Definition, "First Trading Day" (noting First Trading Day "will be specified in each DBOR Contract"); Cantor Rule II–3(b) (discussing fluid DBOR Determination Period).

[9] *See* Cantor Rule I–1, Definitions, "DBOR" and "Rentrak Theatrical." (Emphasis added.) Rentrak Theatrical is a unit of the Rentrak Corporation. *See www.rentrak.com.* Nielsen was acquired by Rentrak and no longer separately reports motion picture box office numbers. Accordingly, our comment will address reporting by Rentrak only.

[10] Cantor Rule II–10.

[11] If the motion picture fails to achieve wide release status prior to the end of the 12th Release Week, the DBOR Determination Period will conclude at the end of the 12th Release Week. Cantor Rule II–3(b).

day in 650 theaters.[12] The "Final Settlement Price" will be a fractional equivalent of the gross DBOR over the DBOR Determination Period.[13]

When trading on any particular Cantor contract will commence is not clear from the Cantor rules; it appears that, at Cantor's discretion, it could commence anytime between a year and one day before a motion picture's release and presumably start dates could vary from contract to contract.[14] The time period of the DBOR Determination Period might not be knowable at the time trading commences—that period could span from 4 to 12 weeks, depending on if and when a motion picture first qualifies as a "wide release."[15] Accordingly, at the time trading commences, traders would not even have notice of the terms of their bets. It also is unclear when trading will end. The chart accompanying the latest Cantor contracts submission (for "The Expendables") states that "The longest trading period for a DBOR contract is a period of four Release weeks." If trading must cease no later than four release weeks after the opening, trading could be limited to a shorter time period than the DBOR Determination Period. For example, theoretically, trading would end *4 weeks* after the opening, but the DBOR Determination Period could be the first *6 weeks* following release, if a motion picture fails to qualify as a "wide release" until the third week after its release. This can cause substantial uncertainty for pricing and perhaps invite gaming. In contrast, the definition of "Last Trading Day" in the Contract Terms and Conditions states that "the Last Trading Day shall under no circumstances be any earlier than the Tuesday following the close of the DBOR Determination Period." Pursuant to this definition, trading could last as long as 12 weeks for a motion picture that fails to achieve wide release status. Significantly, under this definition, trading potentially could extend beyond the DBOR Determination Period—*after the settlement price is known publicly or by those with inside information.*

B. The MDEX Contracts

MDEX's proposed Opening Weekend Motion Picture Revenue Contracts ("the MDEX Contracts") include a binary option and collared futures contract. The MDEX contracts are designed to provide a means to profit from bets on the box office numbers of the opening weekend for "major releases." MDEX's proposed binary option contracts would be issued over a series of strike prices (tied to the level of first weekend box office numbers as reported by Rentrak) that would be exercisable only upon expiration (European style) and only if the strike price for the reported first weekend box office numbers is reached. Upon successful exercise, the purchaser would be entitled to receive $5,000 per option contract.

MDEX's proposed "collared futures" contracts also would offer exposure up to $5,000 to the outcome of a particular revenue period, but are not binary and, there-

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[12] Cantor Rule I–1, Definition, "Wide Release."

[13] Each contract will be settled at the equivalent of one millionth of the gross DBOR for the United States and Canada showings over the DBOR Determination Period—*i.e.,* if the gross DBOR over the DBOR Determination Period are $56 million, the Final Settlement Price of the contract would be $56. Cantor Rule II–3(a). Upon settlement, each buyer of Cantor contracts who holds them to maturity will be entitled to receive, and each seller will be obligated to pay, one millionth of the gross DBOR for the DBOR Determination Period. Cantor provides the following example in Rule II–13(a): If an underlying motion picture title has earned a DBOR of $56,455,000 during the DBOR Determination Period, the Final Settlement Price would be calculated by dividing $56,455,000 by 1,000,000 (equaling $56.455), and then rounding such amount to $56.46.

A trader's profit or loss on a long position held until contract expiration will equate to the difference between the contract price when the contract was entered into and the Final Settlement Price. Using the example above, if the buyer enters into a futures contract at a price of $50 and holds the contract until expiration, the buyer's profit would be the difference between $50 and $56.46. The seller of such a contract at the price of $50 would lose the difference between $56.46 and the $50 contract price. If a trader liquidates his or her contract position prior to contract expiration, his or her profit or loss will be the difference between the opening and liquidating contract prices.

[14] It is not clear when trading will commence in relation to the opening release, but it appears that there will be an Opening Auction on the first trading day to determine an "Equilibrium Price" for the commencement of trading. Cantor Rule II–11. The description of the Opening Auction has changed during various iterations of the DBOR Contract, and it is unclear exactly how the auction will work. While a contract is open for trading, traders will be permitted to execute trades 24 hours a day, seven days a week. Cantor Rule II–12.

[15] *See* Cantor Rule II–3(b). For example, if a motion picture is released in 500 theaters in Week 1, but is shown in 650 theaters in Week 2, the DBOR Determination Period will be six weeks long, because "wide release" status will not have occurred until the second week, and the Determination Period will conclude at the end of the fourth week after wide release is achieved. If a motion picture never achieves "wide release" status, the DBOR Determination Period will be the full first twelve weeks following the opening, and the Final Settlement Price will be based on the DBOR over the full 12 week period.

fore, offer a range of exposure for each contract from $0 to $5,000. Instead of the strike price present in the binary option contracts, collared futures contracts are based on a range of Rentrak's tabulations of box office numbers, with any payouts based on numbers falling below that range (paying nothing), within that range (paying according to a preset formula), or above that range (paying $5,000). If a movie's box office revenue comes within the range of a collared futures contract, the revenue number is converted into a revenue unit by dividing that range into ¼ increments, from 0 to 100, and then multiplying by $50.

ATTACHMENT B

Variety

April 13, 2010

'Titans' victorious at weekend box office

Final figures put 3D epic on top of 'Date Night'

By Andrew Stewart

When the dust settled on Monday, Warner Bros.' 3D epic "Clash of the Titans" had edged out 20th Century Fox's "Date Night" domestic B.O. debut.

Preliminary estimates had "Date Night" winning the weekend, with $27.1 million; Fox revised the figure downward to $25.2 million.

Meanwhile, "Clash" earned a revised $26.7 million, down slightly from Warner's $26.9 million estimate. The 3D epic dropped 56% in its soph sesh and has cumed $110.2 million.

Paramount and DreamWorks Animation's "How to Train Your Dragon" followed closely, with $24.9 million. The toon slipped only 14% in its third frame, for a total haul of $92.1 million.

"Dragon" scored 65% of its weekend take from 2,165 total 3D locations, while "Clash" saw approximately 50% from 1,632 3D runs. "Clash," which isn't playing on Imax 3D screens, was able to top the box office even with a substantial number of filmgoers opting for the 2D version.

Fox originally had predicted a 34% drop for "Date Night" from Saturday to Sunday, but said the comedy ended the weekend with a steep 49% decline. Studio attributed the drop to the final day of the Masters on Sunday, saying the golf tourney siphoned auds from the comedy's targeted older demo.

Most of the frame's other adult-oriented films, including Lionsgate's "Why Did I Get Married Too?" and "The Bounty Hunter" also took steep hits on Sunday.

The Masters played heavily to older auds, skewing toward male viewers, but also with a surprisingly strong femme aud. The "Date Night" demo was similar, with 52% females to 48% males, and about 60% of the aud over 25.

Despite its second place finish, "Date Night" is off to a solid start, with the popularity of stars Tina Fey and Steve Carell helping it exceed "The Bounty Hunter's" $20.7 opening weekend on March 19.

Family pics like "Dragon" fared best on Sunday, with the toon slipping 38% that day. "Dragon" may lose auds as kids head back to school after spring break, but Par said it expects the toon to hold steady until the studio launches 3D "Shrek Forever After" on May 21.

ATTACHMENT C

'Kick-Ass' slays 'Dragon'

Another swap at B.O. top

By Andrew Stewart (*http://www.variety.com/index.asp?layout=bio&peopleID=3844*)

For the second consecutive week, the top two spots at the domestic box office have swapped places, with this week's No. 1 position going to Lionsgate's superhero comedy "Kick-Ass."

Pic's revised weekend figures held steady on Monday at $19.8 million, while Paramount and DreamWorks Animation's 3D toon "How to Train Your Dragon" dropped from its estimated $20 million to a revised $19.6 million.

The B.O. shuffle comes a week after Warner Bros.' "Clash of the Titans" was renamed the B.O. champ with its weekend actuals, ousting 20th Century Fox laffer "Date Night."

In its soph sesh, "Date Night" saw a solid hold of 34%, claiming the No. 3 spot with $16.7 million, while actuals for "Clash" totaled $15.5 million. Cume for "Date Night" stands at $48.7 million; "Clash" has reached $132.6 million in its third frame.

Without any major tentpole releases entering the market in the past two weeks, solid holdovers have been pitted against aud-specific debuts like "Date Night" and "Kick-Ass."

"Kick-Ass," about an average teenager who dons a superhero persona, played best among young males, with a 60–40% male-female split. The pic's healthy launch could bode well for "Kick-Ass" in repeat frames, as Lionsgate hopes fanboy enthusiasm will help fuel strong word of mouth among wider demos.

"'Kick-Ass' is fantastic, highly original entertainment, and our marketing and distribution teams have brilliantly positioned it for a long and successful run," Lionsgate prexy Joe Drake said in a statement. "That kind of run is precisely what we are seeing on the international front, where 'Kick-Ass' has demonstrated a very strong hold at the box office."

The film has grossed some $13.8 million internationally, since its early bow overseas April 2.

Meanwhile, "Dragon" saw a strong hold in its fourth frame, slipping just 21%. The toon's 3D component helped boost holdover potential, which accounted for 65% of the weekend take on 56% of the total location count.

"Dragon," whose cume reached $158.3 million as of Monday, should have a clear playing field until Par/DWA's "Shrek Forever After" is released May 21.

The CHAIRMAN. Thank you. We would like now to recognize Mr. Harbinson, international representative, International Alliance of Theatrical Stage Employees and on behalf of the Directors Guild of America.

STATEMENT OF SCOTT HARBINSON, INTERNATIONAL REPRESENTATIVE, INTERNATIONAL ALLIANCE OF THEATRICAL STAGE EMPLOYEES, ELLICOTT CITY, MD; ON BEHALF OF DIRECTORS GUILD OF AMERICA

Mr. HARBINSON. Thank you, Mr. Chairman. I am very happy to be here. Chairman Boswell and Ranking Member Moran, I appreciate this opportunity to appear before you. My name is Scott Harbinson, and I am an International Representative for the International Alliance of Theatrical Stage Employees. I am here today representing both IATSE and the Directors Guild of America.

I hope my presence, along with that of others in the industry, will underscore the grave concern we have about the impact of movie futures contracts which are pending before the CFTC.

IATSE is a labor union that represents 110,000 technicians, artisans and craft persons in the entertainment industry who work in live theater, motion picture production, and trade shows. The DGA represents over 14,000 directors and members of their directorial teams who work on feature films, scripted television, news, sports, commercials, documentaries, and new media both here and abroad.

The realities of our business are not easily deciphered by those outside of it. The glitz and glamour of the international blockbusters give rise to misperceptions about our industry. So let me just begin with a few of the realities which I hope will shed light on our concerns about the MDEX and Cantor Exchange futures applications.

The majority of the people working on the creative side of our industry earning middle class incomes do not hold regular, full-time Monday–Friday jobs. Ours is a freelance business. People move from one employer to another, and from one production to the next. Our business model recognizes and accounts for that significant uncertainty by providing another form of security to help people in between jobs either directly or through contributions to our multi-employer health and pension plans. This takes the form of residuals

which come from the exploitation of our work in secondary markets such as DVDs, free and pay television, and new media.

Not surprisingly, there is a high correlation between box office success and downstream revenues, and hence the residuals generated in these markets. The ability to trade on a film's box office receipts through movie futures exchanges, exchanges where shorting a film can be extremely lucrative, puts the commercial success of the film at even greater risk. This new risk will not be generated by people who spend years and invested millions of dollars in making the film; rather, it will be generated by those who are likely to have no real stake in seeing a film succeed. Their goal is simply to make money for themselves.

What will follow will be diminished downstream revenues. When that happens, it is our members and their health and pension contributions that suffer. Additionally, the lower film revenues dampen reinvestment which leads to decreased production and fewer jobs in the future. The image of speculators profiteering on our industry to the detriment of working men and women has an uncomfortably familiar ring to it.

The people who work on a film put a great deal of talent, craftsmanship, time and energy into making motion pictures. Directors, in collaboration with many other talented individuals, can spend years of their lives putting a film together. While the studios have a slate of films each year, a director only has a single film. It is highly improbable that a director would purposely seek to undermine his own work by shorting it, and most directors have no need to bet the over on their pictures because their personal service agreements generally contain provisions for awarding strong box office performance.

Other talented individuals who collaborate on the making of a motion picture also have a similar commitment to the final work—the cinematographer, the editor, the production designer, just to name a few. A successful film is recognition of their talent and hard work as well. And with the funding of their pension and health plans dependent on the picture's success, they too have no reason to bet against their own work.

Movie making already has enormous appeal outside of the industry, and to introduce this new exchange would simply be encouraging mischief at best and criminal conduct at worst. It is not hard to envision certain people approaching individuals working on a film to try to secure potentially material nonpublic information, information that they will use to shape the value that they assign to that movie's contracts in the future. Films, both big and small, would be adversely affected by the exchanges in different ways. Larger productions, with so much riding on them, are often being worked on until the very last moment, making them especially vulnerable to a sudden blast of negative publicity. Smaller films have little financial cushion and the impact of rumor and negative speculation can be ruinous to these worthwhile projects.

In this business, there is no magic formula for success, regardless of the hard work and talent involved. For every unexpected hit, there is a corresponding flop. That is the risk that both those who finance motion pictures and those who create them acknowledge on each and every film, but at least those assuming the risk

have a *bona fide* relationship with the work and a stake in the successful outcome of a film. Those involved in the exchanges will not.

In closing, we understand what the existing legal standard is for establishing a futures market. But as a matter of public policy, if the stakeholders large and small have no interest in hedging the risk through a futures market, which admittedly serves no price discovery function, then the government shouldn't sanction it. If the stakeholders have no intention of participating in these futures markets, then the markets will be left to the gamblers. If the CFTC does not have the authority to deny the applications to create movies futures contracts, then we believe Congress should act to address this issue directly. Thank you for your consideration.

[The prepared statement of Mr. Harbinson follows:]

PREPARED STATEMENT OF SCOTT HARBINSON, INTERNATIONAL REPRESENTATIVE, INTERNATIONAL ALLIANCE OF THEATRICAL AND STAGE EMPLOYEES, ELLICOTT CITY, MD; ON BEHALF OF DIRECTORS GUILD OF AMERICA

Thank you, Chairman Boswell and Ranking Member Moran for this opportunity to appear before you. My name is Scott Harbinson and I am an International Representative of the International Alliance of Theatrical and Stage Employees (IATSE). I am here today representing both IATSE and the Directors Guild of America. I hope my presence, along with that of others in the industry, will underscore the grave concern we have about the impact of the "movie futures contracts" which are pending before the Commodity Futures Trading Commission.

IATSE is the labor union that represents technicians, artisans, and craftspersons in the entertainment industry, including live theater, motion picture and television production, and trade shows. IATSE was formed in 1893 and has over 110,000 members. Through its international organization and its autonomous local unions, IATSE represents the behind-the-camera crafts on over 90% of all motion pictures with budgets over $1.5 million produced in the United States.

The Directors Guild of America represents over 14,000 directors, and members of what is called their directorial team, who work in feature films, scripted television, news and sports, commercials, documentaries, and in new media. DGA members live and work throughout the United States and abroad.

Ours is perhaps the most heavily unionized industry in the country, providing good, middle-class jobs with pension and health benefits for tens of thousands of Americans. Our industry is also one of the few that can be counted on to turn in an international trade surplus year-after-year.

However, the realities of our business are not easily deciphered by those outside of it. The glitz and glamour, the international blockbusters, can give rise to misperceptions about our industry. I fear that the misperception that there is easy money to be made in Hollywood is what we are addressing today. So let me begin with just a few of the realities, which I hope will help shed light on our concerns about the MDEX and Cantors Future Exchange applications.

First, the majority of people who work on the creative side of our industry, earning middle class incomes just like most of your constituents, do not work as regular full-time staff at a Monday through Friday job. Ours is a freelance business—people move from employer to employer and from production to production, often on a daily or weekly basis, and always with an eye on their next job. Our business model recognizes and accounts for the reality of significant uncertainty and insecurity by providing for another form of security to help people in-between jobs, either directly or through our industry health and pension plans. This takes the form of payments, called residuals, which come from the exploitation of our work in secondary markets such as DVDs, free television (including broadcast and basic cable), pay television, and most recently new media. Not surprisingly there is a high correlation between box office success and downstream revenues, and hence residuals, generated in these markets.

Unlike other business ventures, the commercial success of a motion picture defies quantification or reduction to a formula. Introducing a large new variable into the production equation poses a significant danger. The ability to trade on a film's box office receipts through movie futures exchanges—exchanges where the creation of a negative perception of a film can be extremely lucrative to those "shorting" it—puts the commercial success of the film at an even greater risk. And, this new risk would

not be generated by the people who spent years and invested millions making the film, rather it would be generated by those who are likely to have no real stake in seeing the film succeed so they can share in the reward—their goal is to make money for themselves. Looking further down the line, if this "manufactured" negative perception succeeds in hurting the film's box office, then what follows will be diminished downstream revenues. When that happens, it is our members, the individual employees and their health and pension plans that suffer. Additionally lower film revenues dampen reinvestment which leads to decreased production and fewer jobs in the future. So, at the end of the line, people who have no stake in the vitality and economic health of the industry will make money and the working people who invested their talents will bear the greatest impact. The specter of speculators pillaging our business to the detriment of working men and women has an uncomfortably familiar ring to it in today's economy. We hope this will not be set in motion against our industry on your watch.

Second, a film on the screen—from conception to post production—is a complex and hard won process. The people who work on a film put a great deal of talent, craftsmanship, time and energy into making that motion picture. Let me offer some perspective on the roles of the director and the craftspeople and technicians. It is universally recognized that feature film is a director's medium and for that reason the director's investment is unique. Directors can spend years of their lives putting a film together, in collaboration with many other talented individuals. While the studios have a slate of films each year, the director only has his or her single film. So of course the success or failure of an individual film can have a huge impact on the director—not just economically but also in terms of their reputation and stature, both now and in the future. Outside of sports franchises, few businesses are so clearly identified with a single individual. So when derivatives are sold one identifiable person is not as greatly at risk as they are here.

From this perspective, it is highly improbable that a director would purposely seek to undermine his/her own work at the exact time when there is the greatest at stake in its success. And, most directors have no need to "bet the over" on their pictures because their personal services agreements generally contain provisions rewarding strong performance at the box office, whether in the form of box office bonuses or profit participation, or both. This is in addition to enhanced residuals income driven by better box office performance.

While other talented individuals who collaborate in the making of a motion picture might not have quite the same stake as the Director, most have a similar commitment to the final work. The Cinematographer who shot the film, the Editors who put hundreds of thousands of frames together, the Production Designer who brings the "look" of the film to life, just to name a few—the film is also a recognition of their talent and hard work as well. And, with the funding of their health and pension plan dependent on a film's success they too have little reason to "bet against" their work.

A film employs hundreds of people at any given point in time. Movies most closely resemble the military in terms of their precise, highly regimented structure. And, as you would expect with the process of creating something from nothing, there are disruptions all along the way . . . and most people have limited or incomplete information about what is going on. Movie making already has great appeal to "outsiders," and to introduce this new exchange into the mix you are simply encouraging mischief at best and criminal conduct at worst. It is not hard to envision certain people approaching individuals working on a film to try to secure potentially material non-public information—information they will use to shape the value they assign (or give others to assign) to that movie's contracts in the future.

In addition it is common industry practice to hold screenings/previews of a film to which members of the public are invited before the film is finished. Hundreds of people view the incomplete film and make comments. It is easy to see how a preview that does not go well can become a factor in "betting" on its box office—and tanking a film before it even gets to the screen.

It is the bigger movies—the very ones that will be on the most screens—that are the most likely to be worked on until the very last moment. The bigger the movie, the bigger the anxiety, the later the final okay is given. Because so much is riding on them and because of this they have a very high vulnerability. At the other end of the spectrum, the lower and mid-size budgeted films—the Junos, the Hurt Lockers, the Little Miss Sunshines—have a different but equally as important vulnerability. They have little margin of error—with tight financing and schedules, they face their own unique "ups and downs" throughout production and it is far easier to harm their financial success through misplaced rumors or perception that they are worth betting against at the box office. In short, the possibilities these ex-

changes create for mischief and even disruption of the filmmaking process are unlimited—and in our warp-speed Internet age—impossible to control.

Third, it is well understood in our business that there is no hard and fast "formula" for success regardless of the hard work and talent involved—in fact success for any motion picture is never a foregone conclusion. All of the percentages and numbers these two groups present to discuss the viability of their exchange obscure an important fact—a film is not a fully-formed object created in a vacuum. Each one is different and unique and nobody knows going in if it will connect with the audience. For every unexpected hit there is an unexpected miss. That is the accepted risk that both those who finance motion pictures and those who create them recognize and undertake with each and every film. But at least everyone involved in that risk has an actual relationship to the work and a stake in its success. Those involved in these exchanges will not. These exchanges are in effect the same as trading in wheat from a single farm. You bet against the farm and you burn it down. We are hard pressed to think of any other commodity for which the hedging actually threatens the underlying product itself.

Such futures contracts would be childishly easy to manipulate or corrupt to increase the value of short positions. This is particularly true for risky, low-budget motion pictures where there are many individuals who would be able to materially affect the success of the film. There is no such corollary in any other futures market that I am aware of.

We understand what the existing legal standard for the establishment of a future market is. As a matter of public policy, if the creators, craftspeople, theatre owners and producers—both large and small—have no interest in hedging their risk through a futures market, which also admittedly serves no price discovery function, then the government should not sanction it. If the commercial and creative interests in the film industry have no intention of participating in these futures markets, then the markets will be composed of gamblers—many of whom will be playing with a card up their sleeve—wagering against the success of a film. If the Commodity Futures Trading Commission does not have the authority to deny the applications to create these two futures exchanges and contracts, we believe Congress should address this issue directly. Thank you again for your consideration and for listening to our perspective.

The CHAIRMAN. Thank you. We have just been notified there will be votes, but we will finish your presentation and get into some questions.

We now recognize Mr. Schuyler Moore, partner, Stroock & Stroock & Lavan, LLP.

STATEMENT OF SCHUYLER M. MOORE, ADJUNCT PROFESSOR, UCLA SCHOOL OF LAW; ADJUNCT PROFESSOR, UCLA ANDERSON SCHOOL OF MANAGEMENT; PARTNER, STROOCK & STROOCK & LAVAN LLP, LOS ANGELES, CA

Mr. MOORE. I am here in my role as an academic, not as a partner at Stroock & Stroock & Lavan. I am an Adjunct Professor at the UCLA School of Law, and I am Adjunct Professor at the UCLA Anderson School of Management. I am an author of the book called *The Biz* which is about the financing of the film industry and a book called *Taxation of the Entertainment Industry.* And I plead guilty to perhaps starting this entire concept in an article I wrote 7 years ago about this precise concept, about structuring investment based on box office results.

It is my belief that this is an absolutely standard, run-of-the-mill necessary technique for film financing. It is the next step in a long evolution, and the first thing I want to get out of the way is every investment in film is gambling. The studios gamble. Investors gamble. That is the industry. We all accept that. It is legal. Film is gambling. We should put that beyond us.

Second, the studios have hedged film risk for 30 years. It is what I do for a living. Co-productions, split rights transactions, presales,

slate financing. In the last 8 years alone, there have been over $10 billion of slate financing and every single one is a way for the studio to get off risk and unload the risk on investors. Every single one. This is what the studios have done for years and years. Every technique I have mentioned, co-productions, split right transactions, presales, slate financing is all to get off risk.

What this exchange offers is an efficient, transparent way for the studios to get off risk. When they figure it out, when they understand it, they will do it and they will do it in droves, just like they do the current slate financing in droves. For the same reason that they did $10 billion of slate financing, they will be doing $10 billion of hedge financing. They always resist what is new. They resisted television. They resisted video. They resisted video on demand. New things scare people. The government itself objected when interest rate swaps were first suggested, and now it is a trillion-dollar-a-day market. So there is a fear of something new, but the truth is this is the way the world has been working.

I read an MPAA submission that said the studios won't do it, and they do do it. That is what they do. I read one position that said they couldn't do it because they have anti-disparagement clauses in their contracts. Every time they do a hedge transaction on the slate deals, they are betting against their film. This isn't new, okay.

From the investors' perspective, it is absolutely needed because there is a pullback in investment in Hollywood due to the fear of opaque Hollywood accounting, whether it is true or not. It is the image.

You can't stop investors from investing in films. They are investing in films. You are worried about investors gambling, they are doing it now on a single film basis, on a slate basis. They are buying stocks in film companies. They are gambling. All this does is it creates an efficient, transparent market where they can look up in the paper and figure out what their investment is worth the next day, just like they look up and see what the stock price is the next day. This is absolutely needed. It will create a huge market for the studios. They will come to appreciate this once they understand it.

I have heard arguments against it based on manipulation. First of all, the first comment is studios can ignore all manipulation if they don't want to be in the market. What do they care if it is being manipulated, right, just stay out of the market. If they are in the market, the only ones, the real ones that can manipulate it is the studios by shorting their own film and tanking it, like the film *The Producers.* I don't think that is something that will happen. I think the studios would lose more on the film and in good will and on their stock price than they would make by shorting their own film. I have no fear of that.

The other thing I have heard, oh, my God, Dr. Evil will sneak into the lab and steal a print to go on the Internet to ruin box office receipts. That risk is so—it is as much a risk as Dr. Evil will put smoke bombs in theaters to keep down attendance. It is just not realistic. So I don't think manipulation is a serious issue.

Insider trading is a bugaboo. There is no legal impediment on insider trading on a commodities exchange, period, or a farmer wouldn't be able to trade corn futures, right, because as an insider

he knows his crop is bad. It is the same thing in the industry. There is this firewall that I frankly think they shouldn't have done. The actual reporting of box office is self-regulating. There is an efficient mechanism in place. There shouldn't be a firewall because that has gotten people off into this red herring of oh, my God, insider trading. There should be absolute, no prohibition on insider trading in my view. And certainly there is no legal prohibition on it.

I would like to address the real reason why everyone is against this is the singular focus that, oh, my God, it is going to trade back. When you look it up, there will be bad trading. Oh, my God, bad buzz about a film and therefore, no one will go to it and the industry will fall apart.

Number one, there is already so much buzz about a film the moment it starts production. There is a website called *aintitcool.com.* There is a website called *rottentomatoes.com.* There is a Hollywood Stock Exchange that has been around for 10 years that hasn't affected a single box office result. They use play money but you can look up and see how a film is tracking. There are real exchanges that do this offshore where you can look up and see how a film is tracking. So there is not just a buzz now but a roar of prerelease publicity news information about a film, and this is going to be a drop in the bucket.

What they are overlooking is how about the good news when a film is tracking well? By the way, it should be tracking more. I would think overall most films better than flat, and so maybe that will spur attendance and so it will turn out to be a wash. So I don't think this whole bugaboo of bad films is warranted.

[The prepared statement of Mr. Moore follows:]

PREPARED STATEMENT OF SCHUYLER M. MOORE, ADJUNCT PROFESSOR, UCLA SCHOOL OF LAW; ADJUNCT PROFESSOR, UCLA ANDERSON SCHOOL OF MANAGEMENT; PARTNER, STROOCK & STROOCK & LAVAN LLP, LOS ANGELES, CA

1. I am an adjunct professor at the UCLA School of Law and the UCLA Anderson Business School, teaching film financing. I am the author of a book called *The Biz: The Basic Business, Legal, and Financial Aspects of the Film Industry* and a treatise called *Taxation of the Entertainment Industry.*

2. I may have started this box office exchange (the "Exchange") concept in an article I wrote titled "Raising Film Financing by Betting the Box," that was published in the *Entertainment Law Reporter* in May 2003. A copy of that article is attached.

3. *Value of the Exchange for Hedging for Studios*

3.1 Hollywood has hedged performance risk a myriad of ways for many years.

(a) Co-Productions among studios (sharing the budget and splitting the world between domestic and foreign);

(b) Split-rights transactions, where all foreign rights are pre-sold to a consortium of foreign distributors;

(c) Pre-sales, where film rights are sold for up front fixed payments (and less on the back end); and

(d) Slate financing transactions, where investors co-finance 50% of the cost of a slate of films for 50% of the profits.

3.2 This Exchange offers a transparent, efficient hedging technique. It will vastly lower hedging transaction costs. Once the studios understand it, they will embrace it strongly *in lieu of* inefficient hedging techniques they currently use.

3.3 One of the submissions by the MPAA stated that the studios would not use the Exchange to hedge due to contractual and practical constraints on disparaging their own film, and hedging would be viewed as disparagement. However, this identical argument could be made with respect to every form of hedging, and as set forth above, the studios have used various hedging strategies for years.

4. *Value of the Exchange for Investing in Hollywood*

4.1 Investors have been taking the significant risk (for both profit and loss) of investing in films for many years:

(a) Investing in stock of film companies, including options, calls, *etc.;*

(b) Investing in particular films;

(c) Investing in slate financing transactions (over $10 billion of such investments were done from 2002–2008).

4.2 This Exchange offers a transparent, efficient investing technique. It will vastly lower investing transaction costs. Most importantly, it completely eliminates the fear of opaque "Hollywood accounting," even if unjustified. Just as an owner of public stock can look in the paper to see the value of their shares, the owner of a position on the Exchange could look at the box office results in the paper and know if the value of their investment.

4.3 The Exchange is not gambling, since investors can make informed decisions based on what they think of the prospects of a particular film. It is no more gambling than owning stock is.

5. *True Reason for Studio's Objection to the Exchange*

5.1 I believe that the real reason for the knee-jerk opposition of the studios to the Exchange is their fear that there' will be widely publicized "criticism" of a film in the form of the quoted price on the Exchange. If a film is trading "low," the public might not want to go see that film.

5.2 The answer to this concern is that there is already widely available "buzz" (if not a roar) of public criticism (good and bad) on films, including numerous popular blogs (*aintitcool.com* and *rottontomatoes.com*) and, most importantly, the Hollywood Stock Exchange (*hsx.com*), which has run exactly this type of Exchange for years (but with no real cash), and Intrade runs this type of Exchange for actual cash. Thus, there has always been and will always be a plethora of publicly available criticism (both good and bad) on films. In all events, fear of bad buzz is not grounds for stymieing new, efficient means of investment.

5.3 In addition, any unwanted bad publicity from short positions on some films will be made up for by good publicity from long positions on other films.

6. *Alleged Fear of Manipulation*

6.1 The studios have mentioned fear of manipulation as a grounds for objection, but this can't be their real concern since they don't have to participate in the market at all, so they could be completely indifferent to manipulation. Indeed, when the issue is raised at all, the risk is that the studios, not the public, will manipulate the Exchange.

6.2 The only possible manipulation would be if a studio went short on the Exchange and then intentionally tanked its own film (*e.g.,* "The Producers"). But this will not happen in practice, since it is highly unlikely that the studio will make more profits on the Exchange than it loses on the film and in future good will (and its stock price).

7. *Alleged Fear of Insider Trading*

7.1 The studios have mentioned fear of insider trading as a grounds for objection, but once again, they don't have to participate in the market at all, so they could be completely indifferent to any alleged insider trading.

7.2 In any event, I don't believe that insider trading laws apply to futures exchanges, and for good reason; oil and studio executives really don't have much better information than what is otherwise widely known and available, and their guesses of future oil or box office prices are often wide of the mark. The truth is that no one knows how well a film will perform before it opens. As the great screenwriter William Goldman said, "No one knows anything," and that certainly goes for the prognostication of box office results.

7.3 If insider trader laws applied here, then farmers would not be able to trade corn futures, since they would be "insiders."

8. *Alleged Fear of Increased Piracy*

8.1 One of the objections raised was that someone buying a short position would attempt to pirate the film in advance and put it on the Internet to reduce box office results. The actual impact on box office results of such piracy are so miniscule that no one would be seriously tempted to attempt piracy for this reason.

ATTACHMENT

Raising Film Financing by Betting the Box

By Schuyler M. Moore

This article suggests a model for film companies to (a) limit their risk on films and (b) raise film financing. But first, some background: Many film companies want to reduce their risk on films, particularly large budget ones. Reducing risk avoids the company going down for the count if the film flops, and it permits the company to spread precious cash over a wider number of films. Perhaps the most common way to achieve risk reduction at present is to enter into split-rights transactions, where two or more companies co-finance a film, with one taking domestic rights, and one or more taking foreign rights. Even when these deals involve a sharing of profits between the two territories, the net result is to give valuable distribution rights, and about half the profits, to competitors. This approach has become widespread, including for "Titanic," "Cast Away," "The Hours," "Tomb Raider," "XXX," and "Terminator 3." While this approach achieves the desired goal, it is somewhat like selling off the family jewels as a hedge against volatility in the diamond market. Film companies are in the business of owning and exploiting film rights, and if there were a logical way to reduce risk while keeping the rights, they would jump at it.

Historically, a great way to hedge risk while retaining film rights was to raise equity through public or private film funds, starting with Silverscreen for Disney in the 1980's. But these funds have long gone the way of the dinosaur. While it is common to blame the demise of these funds on the loss of the tax deduction for "passive losses" under the 1986 tax act, the passive loss rules generally do not apply to corporate investors; if the transactions made sense, there would still be a well-funded market for them. The true reason for the absence of these funds is that most funds felt victimized by opaque Hollywood accounting. Just watch investment bankers shudder when you offer them a share of a film's net profits. Eddie Murphy's great quip—calling a share of net profits "monkey points"—best summarizes the vast public perception of what it means to invest in films. It is for this reason that the U.S. equity market for film financing has dried up.

Yes, there are still some equity investors out there, but they are far and few between, ranging from random rich star-struck investors to German or U.K. film funds. But because of Adam Smith's immutable law of supply and demand, these equity sources often ask for more than film companies are willing to pay. It behooves film companies to come up with a solution that vastly increases supply, bringing prices down, rather than muddling through looking for needles in haystacks. The strong film companies can, of course, raise debt financing, but aside from outright default, debt does not shift risk. What is needed is equity financing.

So here's a suggestion for an approach that might revitalize the U.S. equity market for films: End the accounting miasma, and tie the investors' return directly to a percentage of the gross domestic box office receipts to the theaters ("Domestic Box") for the film. This approach raises the curtain of negativity and doubt that surrounds Hollywood accounting and leaves a spotlight on the glamour and thrill of "owning a piece" of a film. Talk about transparent accounting—all the investor would have to do is open the trades. Accounting statements and audits would be history. The film company would pay the investors the specified percentage of Domestic Box, even though there is only an indirect link between Domestic Box and the film company's ultimate net profits. From the film company's perspective, this transaction hedges risk, which is exactly what it wants to do. To some extent, the transaction resembles a simple wager about the box office results of a film, and this is something everyone can understand to the point of being common coffee klatch chatter, so it would open the investment door to the general public. There is even an on-line service (*BetWWTS.com*) that allows the public to place bets on the Domestic Box of large films, and film companies should be tapping into this potential financing source. It could be done across a slate of films or film-by-film, with investors placing their bets on particular films of their choice. Once the market became efficient, investors could place their bets and invest up to perhaps the day before a film's release.

A simple example may best illustrate this suggestion: Assume that a studio wants to produce a $100 million film, but it wants to limit its risk to $50 million. One approach would be to sell off all foreign rights to one or more other film companies for $50 million, but it will lose foreign rights forever to competitors and with it about half the potential profits from the film. Instead, it raises $50 million of equity with a film fund that provides the investors with a payment equal to 50% of the Domestic Box. If the film flops and comes in with a Domestic Box of $10 million, the studio pays the investors $5 million, keeps the $45 million balance of the investment, and is happy. If the film has a Domestic Box of $100 million, the studio pays the investors a break-even payment of $50 million, and the studio is happy because it will keep worldwide rights and profits to a successful film. If the film scores big and has a Domestic Box of $200 million, the studio will pay the investors $100 mil-

lion, and the studio is *still* happy because paying an extra $50 million to the investors is cheaper than losing all foreign rights and half the profits on this blockbuster forever to competitors, which was the alternative.

More good news all around is the accounting and tax treatment of the transaction. For accounting purposes, the investment will be treated either (a) as a reduction in the cost of the film, with any payment owed to the investor being added to the cost of the film when accrued or (b) as equity, thus lowering the film company's debt/equity ratio, which is an even better result than off-balance sheet financing, which has no impact on the company's debt/equity ratio. For tax purposes, the investment should be treated as a tax-free equity contribution. There is some risk of the transaction being treated as a taxable sale of a future income stream, but this result can be avoided by structuring the transaction as a partnership for tax purposes with the film company. Any loss should be deductible to the investors as an ordinary loss, although any profit should be taxable as ordinary income, not capital gain.

In all cases, the transaction will be treated as the offering of "securities" by the film company, so it must be careful to comply with the securities laws. This is the one significant hurdle to creating enough volume for an efficient market. In the beginning, the easiest approach is to use only "private offerings" to "accredited investors." If the market and size of the offering justifies it, the next step would be to do a registered offering, perhaps even with public trading. (Imagine having to add "Film Futures" to the Chicago Exchange.)

In order for these transactions to work, the investment must be refundable with interest if the film does not end up with the promised key cast and director or does not get a theatrical release on a minimum number of screens by a specified date. Because the film company will be required to make payments to the investors (whether due to the film not meeting the promised conditions or based on Domestic Box) regardless of actual net profits received by the film company, the company will have to either (a) have a strong enough balance sheet to make the investors happy or (b) hold the investment in escrow until the Domestic Box results are in, precluding the investment from being used to cash flow production. Even if the investment is escrowed, the investors still will be relying on the film company to pay any amounts owed to them in excess of the investment if the Domestic Box is high enough. These factors militate toward making this transaction easier for the studios (the rich get richer), but it is not beyond the reach of well-heeled independents.

Would it work? Bet on it.

The CHAIRMAN. Mr. Moore, you are very much into this. Thank you. We will have an opportunity to continue this during the questions. We appreciate your testimony and thank you very much.

I will just ask one quick question before we recess for votes. I will address this to the first two witnesses. If the big movie houses would stay true to their word and refuse to participate, would your contract be viable?

Mr. JAYCOBS. Yes. The answer is yes. There is an enormous investor class that actually has investments, and to Mr. Moore's comments, actually has investors here, and we think that makes a very legitimate market all by itself.

We also have the Lionsgate letter that says if not the MPAA members, the other smaller studios will participate. I was recently at a film conference with small film producers who were very enthusiastic about the concept.

I think the MPAA has done a very good job of bringing a group together, but it doesn't represent the entire industry and we will have a very successful market.

Mr. SWAGGER. To add to what Mr. Jaycobs shared, a notable Hollywood individual once said, "Where there is smoke, there is a smoke machine." We believe that is certainly the case here. There is viable use for this product and a wide group of recipients looking forward to using this product.

The CHAIRMAN. Thank you. We are going to recess now until these votes are completed. Sometimes they drag out a little bit. The first one is a 15 minute vote, and there will be 5 minute votes. We

will come back as soon as we can and try to finish at that time. I apologize for the inconvenience, but like you I have no control over that. We are in recess.

[Recess.]

The CHAIRMAN. We will call the hearing back to order. Mr. Moran will be here shortly, and he said it is okay to commence without him, so we will, in the interest of time. And I have a couple more questions and then we will yield. So back again to our first two presenters. Mr. Jaycobs, Mr. Swagger, how far ahead of a movie premiere will you offer the contract on that movie's receipts?

Mr. JAYCOBS. In the case of the Cantor Exchange, the provision is up to a year, but we expect it will be 6 months.

Mr. SWAGGER. In the initially proposed application, we are looking at 4 weeks.

The CHAIRMAN. Okay. Who will be using these markets for price discovery purposes or *bona fide* hedging, in your opinion?

Mr. JAYCOBS. Again, to reiterate in my opening comments many deals are negotiated on the basis of what a box office potential will be. The amount of advertising that is justified by a film will be reflected by the expectation of that box office; the number of theater screens and seats that are allocated to it will be based on that sort of decision.

So, again, I think of it in the farm context: If the price of soybeans or cotton is high or low, there is an allocation question that the farmer uses. And in our case we see those same decisions being made here. If you know the box office in advance, theater screens, advertising budgets, investments decisions can be made using those prices.

Mr. SWAGGER. In fact, to add what Mr. Jaycobs shared. One of the reasons for starting off with the box office weekend product, is the sheer fact that there are so many contractual obligations tied to the success of the box office, to the television and satellite providers, what do they pay for that and who gets the contract, to the DVD distributors and such. There is a lot tied to the success of the box office. And, again, the list of natural users, the original screenplay owners, debt and equity investors, the investment banking syndicates, the talent involved in the film, studios, both MPAA and the other many studios, banks and lenders, insurers of talent movies, theaters, distributors, and the promotional marketing partners.

The CHAIRMAN. Thank you. Mr. Pisano, you heard me ask Mr. Berkovitz about the Iowa Electronic Markets and the futures. These markets are admittedly small, but they exist nonetheless. And all your objections could apply to these contracts. However, our democracy has managed to survive these election markets. If we as Members of Congress could continue to spike contracts where people invest on our elections, why cannot you? And why are movies more special than elections?

Mr. PISANO. Well, first of all, I was unaware of the Iowa situation. And I am advised that that has been the subject of a No Action letter because of its educational purpose. As I understand, it is part of the curriculum of the University of Iowa.

The CHAIRMAN. Well, when it started out that was the purpose. But then they let others invest in it. So that is probably the reason for the question.

Mr. PISANO. Sir, first of all, betting on the outcome of an election is a time-honored tradition in American politics and British politics. And so I distinguish that from the situation we have here, which is an attempt to cloak in the legitimacy of a futures market something that is highly speculative and something that has as its base, as its index, something that doesn't exist. In an election, you know how many votes are cast ultimately when the votes are tabulated.

One of the things I like to point out in terms of how the movie box office reporting works, I think you asked the question of Mr. Berkovitz. There are no real numbers reported. What is reported are estimates based upon surveys and electronic feeds from theaters. And, indeed, the very tracking service that the exchanges propose to rely on, Rentrak, which I am very familiar with, for a number of years has in its terms of service a disclaimer in terms of the use of the information and the reliability of the information, because it is just that: It is an estimate, a pretty accurate estimate. But no money changes hands anywhere in the industry based on what is reported in *Variety* by Rentrak. Also, no money changes hands in terms of the contracts that are downstream based on what is reported in *Variety*. Indeed, those downstream contracts, for example, television contracts, pay television contracts, those are negotiated years in advance and they are based on film rentals, which is the individual share between the theater owner and the studio when it is ultimately settled up. And that is never reported publicly because that is personal private information between the two contracting parties.

The CHAIRMAN. Well, thank you. At this time I would like to recognize Mr. Marshall.

Mr. MARSHALL. I was struck by your testimony, Mr. Moore. It was, as the Chairman described to me anyway, enthusiastic and I thought probably pretty authoritative. I don't think we are really competent to make this judgment. I think it is something that needs to be left to the CFTC and the experts within the CFTC. And I certainly think it is clumsy at best, probably inappropriate, for us to just start listing different products that are not to be subject to futures.

What I am interested in is sort of general guiding principles. And you mentioned that you didn't think it was such a good idea to have the firewall so insider information, no matter where it comes from, is available. You don't worry that the effect of that will be to cause manipulation in inappropriate ways and effectively undermine the attractiveness of the investment from the perspective of people who, "Know doggone well they are not going to be the ones, they are going to get the insider information and know which way this thing is going to move." They will be dumb and they will be the chumps at the other end of the deal.

So without the firewall and with the presence of insider information, in such a narrow rifle shot kind of inquiry, what is going to be the success of this particular venture? Would there be a market at all?

Mr. MOORE. I believe there would be. I believe that the same comment could be made with respect to every market: That there are people with more information and some with less. And that is,

in fact, the basis for our capitalistic system. That is the basis for a free market exchange. The same could be said with respect to farmers being insiders because they know on the ground whether or not there are crop infections, whether there is infestation of locusts or something that before the——

Mr. MARSHALL. So your basic response would be, look, this has been a valuable tool available to other kinds of investment decisions. Make it available. Either the market will take advantage of it or it wont. If the presence of narrowly focused insider information with regard to the end result where box office receipts are concerned for a particular product is a worry, then the investors won't step up. Let the market figure out what?

Mr. MOORE. Yes. I would say there are two separate issues. One is up until the release of the film. And there has been confusion among the Members on this issue, so I would like to be precise.

As to insider trading prior to release of the film, I believe strongly there should just be no limits at all. That is, let the market decide. And I believe that you want to disseminate the information through pricing. And that is the point. And in particular, number one, the truth is there are no secrets in Hollywood. The moment that a film has some trouble with it, it is instantly on the blogs, it is instantly in the trades.

Second, the truth is in Hollywood nobody knows anything. Nobody knows what that box office will do. The top executives at the studio who have all the inside information in the world are often wildly wrong on whether a film will flop or not. There are just endless, countless examples of films that have flopped that people thought were going to be huge and *vice versa.* No one could have predicted *Paranormal Activity*, a $200,000 film, doing as big as it was.

So as to that answer, let it go.

Mr. MARSHALL. Are these products essentially available now in the OTC market offshore?

Mr. MOORE. Yes, they are.

Mr. MARSHALL. And are they robustly traded?

Mr. MOORE. I don't know whether they are robustly traded. There is a company called Intrade that is offshore that is unregulated, not governed by any U.S. laws that is permitted box office betting going on right now.

Mr. MARSHALL. Mr. Jaycobs, Mr. Swagger, how about that? The OTC market. Are there swaps, derivatives that do essentially what you are proposing to do on the regulated markets?

Mr. JAYCOBS. I mean, I don't draw the comparison quite as closely with Intrade. I think that the statements that were made earlier are more consistent with what we have seen, which is that the hedging that is happening now is by transfer of risk through the securities market, not through the futures market. That is the mechanism we have seen.

Mr. SWAGGER. I completely agree with that. And the notion that a CEO would not use this hedge; quite honestly, in our work directly with many of the very constituents at the MPAA, not only were they interested in this initial product, but they were interested in working on the development of different products that would also meet economic needs that they have. And the ability to

collect data was not available 5, 6 years ago in the relative form that it is today. And I think that if there is a concern about the value of that data that is being collected, that is a greater concern than something that has to do with CFTC regulation. If we are understanding from Mr. Pisano that the MPAA is saying that his studios manipulate data that is put in 10–Q reports for large corporate conglomerates that own studios, that would be of great concern.

Mr. MARSHALL. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. The chair recognizes Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you.

I heard Mr. Jaycobs talk about CFTC and the public utility of this exchange. And yet, we heard the General Counsel talk about that is not one of the criteria in which the CFTC looks at. So I want to explore with you and others on the panel, what is the public utility? What is the public benefit of this exchange and this kind of product?

Mr. JAYCOBS. Well, it is twofold. There is the—what we call in this industry the price discovery function. But what other folks would say is, what is the box office going to generate from an economic value point of view? And as we have heard here, many decisions are made on whether that box office is going to be strong or weak, or whether you take the risk of that or not. And it is investment decisions made by individuals in advance of even knowing what films would be produced with the money that they have invested. It is screen allocations. It is the budgets for advertising. There are a number of business decisions that are being linked to that box office value.

Mr. MORAN. And I assume, then, that the theory would be that the market would then become much more efficient. Investment decisions, location of theaters, decisions would be made that were based upon more information.

Mr. JAYCOBS. That is exactly right. If you have more information. And, equally important, that that information can be acted on in a financial transaction. So you can not only have an opinion about the value, but you can actually take an action to ensure that value. You put those together, and in every other instance where we have futures markets, that has been a great benefit to the underlying industry.

Mr. MORAN. Mr. Pisano, do you have a counter argument to that point?

Mr. PISANO. As I said earlier, Mr. Moran, nothing in the movie business today is linked to the reports of box office. As I said, those are simply estimates that we release—our studios release and others, principally for marketing purposes. They are not reported in the financial statements of the companies. They are not reported to the SEC. They are estimates based on the Rentrak system.

And, in addition, no one that I know of—and I have been in this business for 25 years—makes the decision as to how much money we are going to spend on a movie or how many screens are going to get booked based on some artificial estimate of what the box office will be based on a futures trade. So there is an unreality to this market not linked in any way to how the business actually

works. And that is, to me, is part of the danger of this proposal in that what it really does is invite speculation.

In addition, according to the phone book-size set of rules that the exchanges have published, the very people that would have some information and might be able to rely on it are prohibited from acting on it. So what—to put it in its simplest terms—what we have is a market in search of a product that the people who actually participate in the industry don't want, but, perversely, it is going to impose liability, reporting, and regulatory responsibilities that we don't want and don't currently have, and even questionably whether the law as it is written today has the power to impose it on the motion picture producers and distributors.

Mr. MORAN. Mr. Moore, I assume that you have an observation about both of those answers. In addition to that, I wanted to add the question about increased or decreased investment in the movie industry. I think you indicate that, as a result of this additional transparency of information, that we would see an increase in investment. And I want you to explore that a bit with me. But also, if someone could walk me through. Supposedly we have some investor in my home State of Kansas who wants to invest $100,000 in making a movie. How would this help or hurt him or her's effort to make that investment decision.

Mr. MOORE. I can tie all of this together and answer that. It is the perfect question. I guarantee you that there will be an enormous flood of financing into the industry for the studios to create jobs for Mr. Harbinson and IATSE, to create jobs for the guilds, to create more film production if there is an exchange that permits trading based on box office results. Because, number one, if you tell me the box office result of a film, I can tell you with statistical certainty what the total income to the studio will be from DVD and TV, because there is a correlation between box office and the other revenue.

What I would say to your investor in Kansas is right now they have a choice to put $100,000 down and invest it in either a particular film, or they could invest in a slate of films. And they are going to look at you and they are going to say, in exchange for what? And the answer you will give them is, net profits. And net profits is a very opaque accounting term in Hollywood with a lot of ambiguity and a lot of litigation behind it and a lot of uncertainty. And that uncertainty holds back investment. That is what holds back investors.

If your investors in Kansas could hedge their risk in a way that they could know with certainty that if the box office was X, and they could look it up in the paper and they know what they have earned the next day with certainty, they would have that much more comfort, they would become free of the fear of Hollywood accounting, and there would be a flood of funds of financing for the market. I represent—this is what I do for a living, and I can tell you I have had talks with my private equity funds who would flood this market with financing if there was a hedging opportunity available that they could protect themselves. And, I mean, they have told me this. And, I mean, hundreds of millions of dollars. There is no question about it.

Mr. MORAN. Thank you all very much. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Kissell, questions?

Mr. KISSELL. Thank you, Mr. Chairman.

Mr. Jaycobs—and I am probably going to repeat some of the questions that have already been asked, but I am trying to once again just understand this, and I kind of agree with Mr. Marshall, that this is—while it is interesting to hear your comments and your positions, this seems to be a decision best left to the CFTC and their expertise of understanding this at much greater levels than I would.

But, Mr. Jaycobs, why do you want to invest? Why do you want to set this market up? These guys don't seem to want you. Why not take your money somewhere else?

Mr. JAYCOBS. Well, Cantor has had a well over 10 year commitment to try to develop financing vehicles for the entertainment business, broadly speaking. So this is part of that commitment. We think that—very much to the Professor's comments, we think that it is the transparency in a public marketplace that enables us to do financing of films. Without that, we are trying to create investment under the cloak of a market where valuations are being determined arguably by Mr. Pisano's organization as they assess what films are valuable and what films are not valuable. So we think that having a public, transparent marketplace is a predicate to doing all forms of other investments. And, in that sense, I agree with the Professor.

Mr. KISSELL. And Mr. Pisano, and I know we have talked about this. But why don't you want their help? They seem to have some money there. The equity would seem to be something that might leverage your investments. Why don't you want the help?

Mr. PISANO. Speaking just for my members, we have perfectly adequate tools to finance our motion pictures. And all those tools have been discussed, so I won't go into it.

What we don't want to do, what we don't want to do is to participate in a highly speculative, unreal, basically gambling casino effort to raise money. That is not good for our industry, it is not good for our companies. And, as Mr. Harbinson said, it is not good for the creators who are involved in the picture individually.

And, while one could postulate, theoretically, that new financing opportunities are a good thing, I think they are a bad thing when they are like the synthetic derivatives that have driven down and basically almost destroyed the financial structure. This is nothing more than synthetic speculation. I am perfectly happy to have people make money who are speculators, but there has to be a broad economic purpose. And we simply don't see that here. But we do see opportunity for abuse, manipulation, and the kind of financial chicanery that has gone on in this country for the last 5 years, and that is why we are opposed to it.

Mr. KISSELL. Thank you, gentlemen, for your patience while we were voting. Thank you for being here today. Mr. Chairman, I yield back.

The CHAIRMAN. Thank you. Mr. Marshall, you had another question?

Mr. MARSHALL. Mr. Moore, you alluded to reasons why MPAA would not be interested in having this kind of credit facility available. You say that the effect of this would be to enhance dramatically the amount of investment that is available to fund films; so, hence, it would be boom times in the film industry. Besides just saying they are wrong in their evaluation of this, which you clearly think they are, are there things about how MPAA has structured the existing order of things that would be disrupted by this, some sort of vested interest that is being protected that you could perceive and share with us?

Mr. MOORE. No. I really do believe that it is simply the fear of bad tracking, and the fear that that will lower attendance to a film. I think it is a fairly myoptic view, without taking into account that there is going to be good tracking that will increase attendance, and kind of ignoring all the other benefits. And I also think it is just the fear of what is new. I think that has been a historical trait of the MPAA and the studios. I think they would ultimately come to embrace this.

Mr. MARSHALL. So you don't see any attempt to defend turf that exists right now, those sorts of things that—concerns that sometimes come up when new products are offered?

Mr. MOORE. I don't believe so.

Mr. MARSHALL. Mr. Jaycobs, Mr. Swagger?

Mr. JAYCOBS. I can only rely on the comments Mr. Pisano just made, that the major studios don't need this. They have plenty of financing. They have very deep corporate pockets standing behind them. I would point out that they have closed several, New Line, Vantage, Miramax were closed, distribution units that did small films underneath bigger studios. And if you have a public marketplace that creates greater public financing, the independent folks that we talked to, Lionsgate is just an example of that. But it goes down to production companies, they will all have the ability to get access to funds that right now for the most part can come only from the MPAA or its members.

Mr. MARSHALL. Mr. Swagger.

Mr. SWAGGER. I am sorry. Would you mind repeating the question?

Mr. MARSHALL. Well, actually it is the same question I just asked Mr. Moore. I am just wondering, in your opinion, Mr. Moore, Mr. Swagger, Mr. Jaycobs, you are in favor of doing this, making this credit facility available. Is there something that you perceive MPAA is trying to protect, some existing order of things, that would be disrupted by this that explains why MPAA would be concerned?

Mr. Moore says no. He thinks it is a legitimate worry about what would happen to the prediction of success or failure where a movie goes, and the existing order would prefer to leave that to critics and whatever else is presently around and not add yet another thing speculating on success or failure. Mr. Jaycobs is suggesting that there is a little more to it; that MPAA would be perfectly happy with the existing order of things, since financing is available for it but not for the smaller ventures. This would create more financing for the smaller ventures.

Mr. SWAGGER. I would completely agree with that statement. If there is an action taken to prevent these products, the action is really just saying there are six studios we want to protect and we don't want to protect the rest of the jobs, the rest of the talent that is out there. We have great people on our board that have been involved with film financing, and this is certainly a move—if indeed the constituents of the MPAA are all really supporting this. What we have learned in directly working with those constituents, they are very open to not only this product but other products. So I would even disagree with Mr. Pisano's statement that they are all opposed to this is a direct conflict of what our experience has been.

Mr. MARSHALL. And in fairness, Mr. Pisano, if you could give your perspective here.

Mr. PISANO. I was speaking on behalf of the MPAA member companies. But we have in the record already a statement from the Independent Film and Television Producers Association, which represents 150 independent producers of film and television. In fact, in terms of that organization, that is probably the majority—the majority of the films produced every year by their members, and they are opposed to it for all the reasons which they have set out in their filing and I won't repeat them. So it is not just the six studios who are opposing this. It is the Independent Film Association representative that are opposing it, also, for the very reasons set forth.

Mr. MARSHALL. Mr. Harbinson.

Mr. HARBINSON. Well, I am a little different than the rest of the panelists. I am a working person that represents working men and women, so I bring a different perspective to this. But from the perspective of the people I represent, it looks very much like the Wall Street guys are trying to do for the motion picture industry what they did for the real estate and mortgage banking industry, and we don't want it. We don't want any part of it. It has been very well articulated by the MPAA, it has been articulated by us, and it has been articulated by the independent producers. And I am hoping that the Committee sees it that way and realizes that all this is is gambling for a select few to make money at the expense of those of us who make motion pictures.

Mr. MARSHALL. Mr. Moore, last word here in response to Mr. Harbinson? We keep hearing this is just gambling, and Wall Street and the reference to synthetic CDOs.

Mr. MOORE. I hear it. But in truth and in fact, it will—and I wrote this article 7 years ago and it is attached to the material that I submitted to the Committee, that I believed it then and I believe it now that we desperately need a transparent, efficient market to generate substantial financing for this industry. The wave of equity from New York and the private equity funds for the last 5 years has dried up. It was a total of $13 billion. It is gone.

Film—Mr. Harbinson should know that film production is way down. Salaries are down. Prices are down. Profits are down. Films are going bankrupt. MGM—Miramax is being sold at a—and there are a number of other companies that are on the verge of bankruptcy in the entertainment industry. They need financing. This is a viable, efficient, transparent approach to bringing substantial fi-

nancing to Hollywood. It will help the unions, it will help the guild, and it will help the studios.

Mr. MARSHALL. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Pomeroy, any questions?

Mr. POMEROY. Yes, Mr. Chairman. Let me acknowledge at the outset I know nothing about the motion picture industry or how it is financed. I have been interested in the concept of the futures trading relative to potentially assisting in adding security to the investing, the highly risky investing in motion pictures. To me, it seems like this could work fairly nicely. You would have basically a hedge, you would put it out there, and you would basically be able to put a block on your downside exposure. This technique could bring more investors to the party because they are going to have a position that they can secure. They know their risk isn't unlimited.

Mr. Harbinson, I guess I would direct this one to you. It seems to me like more participation in the investing in movies would be to the interest of your members, and yet you have taken a position against this proposal. Have you evaluated whether or not this might be a means to get more investing, and, therefore, more opportunity and, indeed, more independence? I have a theory, utterly baseless other than my own conjecture, that possibly some of the opposition from the Motion Picture Association is because they are the bigs. And if you have a backstop on risk, well, you have more potential investing, you are going to maybe have more little ones. And that is more competitive, in my argument. But, for your members, that might be more work. I am puzzled with this issue in that way. I would like your response on behalf of your members, and then maybe toss it around a little bit.

Mr. HARBINSON. I will answer you as best I can. As I said, I am a union representative, and my normal bailiwick is negotiating and enforcing collective bargaining agreements and processing grievances, that sort of thing. So this is all kind of new to me, and I am trying to get up to speed as best I can.

I think that our fundamental objection is that we are practical people. If it looks like a duck and quacks like a duck, it is a duck. If it looks like gambling, it smells like gambling, it is gambling. We don't want to be—and you are right. Mr. Moore was right. You know, the industry has suffered, and it has suffered as a result of the financial crisis that is now being dealt with. It may come as a surprise, but we don't have great confidence in Wall Street to create new wonderful things for our industry, particularly when we see just how variable a motion picture's success could be. We are concerned about the process being corrupted. We are concerned about the process being manipulated. We have grave, grave concerns over that. Would we like more work? Yes, sir.

Mr. POMEROY. I hear you. I think there could hardly be a worse time to consider a new realm of futures trading in light of the abuse that has taken place in this whole arena. On the other hand, it has long served a useful risk management role in the marketplace for lots of things that are otherwise hard to evaluate risk and how you price risk protection. So you do it basically in an open exchange traded way, and the marketplace determines how you reach a valuation and puts a valuation in place.

I would like to hear from Mr. Jaycobs—and I know, I see my time is up or just about, you have about a minute left to bring your perspective to my conjecture here.

Mr. JAYCOBS. Well, that is exactly our view. Is history—this would be the only case in history where that result was not achieved. And we have great appreciation for Mr. Harbinson's guild and the other guilds. The decline in production has been dramatic. The studios have shifted their production to blockbuster type pictures away, as I just mentioned, from the smaller films. And we also—I had the pleasure to meet with some folks at the Directors Guild and we had an opportunity to present our side of the story. Up to that time, we hadn't. The folks at the Directors Guild explained to us—and I thought it was a very simple concept. If we believe that this will raise more money, and there are good arguments for the industry and there are good arguments in that direction. We would have to be convinced that there was not a reputational risk that because a market was sold off unfairly, that that reputational risk would look bad for our people. And I fully understand that. I think that is where the CFTC's role is so important here, is that we have to make sure for the investors in the market, for the creative people involved in the process, we have to make sure that we have a level playing field for the entire market. The CFTC is expert in that role, and we trust their judgment in working with us to come up with a product that will achieve the greater good.

Mr. POMEROY. I did think that reputational risk is an interesting element. And, again, not having a background in the industry, I thought the point made by Motion Picture Association was interesting that you would have basically *Wall Street Journal* coverage of the first weekend box office, the shorts hit in terms of the futures, and basically you have destruction of the picture in its first few weeks in the marketplace. It would compound the risk already experienced by a weak opening box office or maybe critical reviews. So I understand that. I don't know that that is determinative, though, on the question of whether or not this might be a useful way to backstop risk for purposes of inducing additional investment in U.S. produced films. We will continue to reflect on it.

One question maybe to just—this is a quickie. As we look at futures and exchange trading, do we sort through the many facets of our economy and say, "Well, you can futures trade this one, you can't futures trade that one; you can futures trade tire futures, but you can't future trade some other"—you know what I mean, in that way? Is this a common approach? As a Member of the Agriculture Committee now for many years, I have not seen legislation that would identify an industry and say, well, you can't do it for this one. Sure.

Mr. SWAGGER. I think Rich can add to this as well. From our perspective, no new exchanges can start and be successful unless they are into a new product market. Working at UBS as a banker, working with one of the very constituents actually of the MPAA, they were asking us if we would do slate financing, which is let's finance maybe ten films in a package. And the challenge with slate financing is simply you don't get the best of the films in there. It is not economically a position that we wanted to take when I was with

UBS. In that same discussion with that same studio, who is a member of the MPAA, to which our name was derived from, we started talking about futures contracts, opening up that dialogue, helping them to understand there may be some new tools.

So personally, as an entrepreneur, I felt this was an opportunity to take my hard-earned dollars—and Mr. Harbinson, I am a working man myself, grew up on a farm and spent many years of hard work, and also went through Officer Candidate School in the Marine Corps. And my family grew up in the automotive industry. I have created new jobs to serve a specific market, the entertainment market. And the concepts that we came out with are concepts that were brought from the entertainment industry itself.

Now, granted, I don't have the years of experience Mr. Pisano has in the entertainment industry. What I have is the ability to bring talented people together. One of the top people in movie financing from one of the top banks serves on our team. One of the top producers who produced a lot of great movies that each of you would know serves on our board. One of the top individuals who built the most modern studio in Hollywood is serving on our board and manages $200 million revolving loan funds. We have a lot of talented individuals. Pete Warzell, who works for us who had to step out used to be the former Chairman of the National Association of Theater Owners, NATO, one of the organizations that is supposedly against us.

Before that, he was at AMD building a live program, he was a president of United Artists and the chief operating officer and said, I wish we would have had these products before.

Mr. Pisano and I were talking right before we came back here. We were talking about an area called Century City. Century City in L.A. is the result of a studio almost gone bankrupt, a major studio, one of the MPAA constituents nearly going bankrupt and having to sell off their whole entire back lot. Had there been futures products to protect that industry, not only would it have prevented something like that from occurring, but it would indeed inject capital to help build and create jobs. And at the end of the day, if the six constituents at the MPAA don't want to use the product, that is fine. I am willing to live or die on that sword. But we know—I didn't start a business and invest millions of dollars on pure speculation that a field of dreams, "I am going to build it and I hope they come." We build it on foundational knowledge that there was a dynamic need for this industry.

Mr. JAYCOBS. I don't know if we are over our time, but I did want to answer. I think your question was history. I have been a 25 year futures industry veteran, and so I have seen a lot of new markets get created. And what I can say is common among all of them is the industry that was—energy comes to mind in particular, where a new futures product is introduced and there is significant industry opposition. If we go back to the early 1980s, the Seven Sisters were—and this has been documented in a book. The Seven Sisters were opposed to the idea of creating a NYMEX futures market even on a small scale in the financial markets there was opposition, substantial opposition to creating a 5 year futures contract for Treasury bonds when there was a ten and a different one. And

even those interests all aligned to say we shouldn't have such a thing.

The only case in history that I can think of and is well documented where Congress has stepped in and now started to carve out is the 1958 case where it occurred in onions.

Mr. POMEROY. Onions. If it weren't for onions, we would pretty well let markets determine what makes sense or not relative to the futures.

Mr. JAYCOBS. That is correct. The philosophy always was, if the product is poorly designed—again, dealing with the very important issues of we cannot have manipulation, we must have a fair playing field. But the commercial success, the question of whether they will come or they will not come to the field of dreams in Iowa has always been left to the—basically, to the marketplace to determine.

Mr. POMEROY. Thank you very much. And Mr. Swagger, very strategic getting your farm boy background in before the Agriculture Committee. We are way over time, you guys.

Mr. SWAGGER. May I just clarify one issue? There is a lot of confusion with this smoke about gambling.

Mr. POMEROY. Can you clarify this issue in 20 seconds? Because the Chairman is about to gavel us down here.

Mr. SWAGGER. Absolutely. Thank you, Chairman Boswell.

Gambling, somebody takes on a risk. That is the studios. That is people who finance the movies. Futures market, you assume and spread out the risk. It is not gambling. It is taking the risk that is there and existing and spreading that out. And that is what a futures market has been, has always been, and is in this situation as well.

Mr. POMEROY. Thank you.

The CHAIRMAN. Well, thank you. It has been a very, very informative discussion. But before I go to closing remarks, I would like to recognize my Ranking Member, Mr. Moran.

Mr. MORAN. Mr. Chairman. Thank you very much. Perhaps many of us came here with preconceived ideas. I thought it was a very useful hearing, something that we ought to do more in Congress is get a perspective so that we can make correct decisions. And I appreciate the witnesses' testimony and you conducting this hearing today, and I look forward to analyzing what I heard during the testimony. Thank you.

The CHAIRMAN. All right. Thank you. And I concur. I think it has been very informative, and I appreciate the efforts you made to come and inform us and share with us. We likely will have some more questions as we go forward. It has been a learning experience. And thank you for giving us your time today. We apologize for the interruption for the votes, but those things happen.

So at this point I would share that under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material and supplement the written responses from the witnesses to any question posed by a Member. This hearing of the Subcommittee on General Farm Commodities and Risk Management is adjourned. Thank you.

[Whereupon, at 1:30 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED STATEMENT BY INDEPENDENT FILM & TELEVISION ALLIANCE

Thank you, Chairman Boswell, Ranking Member Moran and Subcommittee Members, for the opportunity to provide a written statement to the Subcommittee on General Farm Commodities and Risk Management of the House Committee on Agriculture, regarding the applications currently before the Commodity Futures Trading Commission ("CFTC") to approve or deny two proposed commodity futures contracts and a commodity option contract sponsored by Media Derivatives, Inc. ("MDEX") and the Cantor Futures Exchange L.P. ("Cantor") that are designed to allow the contracts' users to bet on the level of gross motion picture box office receipts on individual motion pictures ("the proposed contracts" or "the contracts"). The Independent Film & Television Alliance (IFTA) opposes these proposed contracts because they serve no legitimate public interest, would impose new and substantial burdens on small to medium sized businesses and provide little, if any, of the so called "benefits" of hedging; thereby causing disproportional harm to the countless business, financial and creative partnerships which make up the independent motion picture industry.

IFTA is the nonprofit trade association for the independent film and television industry worldwide. IFTA Members consist of over 150 independent production and distribution companies, as well as sales agents, television companies and financial institutions from around the world, the majority of which are U.S.-based producers and exporters.[1] Over the last seven years, independent production companies have produced nearly 80% of all U.S. feature films and producing on average 500 feature films per year. Since 1982, IFTA Members have been involved with the financing, development, production and distribution of 64% of the Academy Award Winning Best Pictures® including *The Hurt Locker, Slumdog Millionaire, No Country for Old Men, The Departed, Crash, Million Dollar Baby, Braveheart, Lord of the Rings, Dances with Wolves* and *Gandhi*. In the past year, IFTA Members films have also included *The Twilight Saga: New Moon, The Last Station, Inglorious Basterds* and Tyler Perry's *Madea Goes to Jail,* to name just a few.

IFTA Members' collective worldwide sales for 2008 totaled over $2.8 billion, of which approximately $2.3 billion came from foreign (non-U.S.) revenue; and $503 million from U.S. revenue, which is approximately 18% of total worldwide revenue. Of the amount for export revenue, $1.7 billion was generated from Europe, $129 million from Latin America, $222 million from Asia.

IFTA is also a member of a coalition opposing these proposed contracts that includes the Directors Guild of America, Inc. (DGA), the International Alliance of Theatrical Stage Employees (IATSE), and the National Association of Theatre Owners (NATO), as well as the Motion Picture Association of America (MPAA) and its member companies ("Coalition"). The Coalition has submitted a separate written statement outlining its opposition of these proposed contracts and Coalition members will participate at the April 22, 2010 hearing. IFTA is filing this Statement individually to underscore the specific concerns of the independent motion picture industry with respect to the proposed contracts.

As a background, independent producers are those companies (apart from the MPAA studios) that assume the majority of the financial risk for the production of a film or television program and control its distribution in a majority of territories worldwide. Independent producers secure financing on a film by film basis with different investors for each film and rely heavily on the distribution commitments of foreign distributors before production of the film even begins. For independents and MPAA studios alike, film distribution is not a "one shot deal" as may be the case with agricultural futures—a picture's long term revenue prospects (especially in foreign territories) can be severely damaged by publicity generated around artificial expectations of the performance of these contracts, which looks at only a small window and only the U.S. release. Therefore, any pre-release hedging by U.S. distributors (which are separate, unaffiliated companies) could harm not only the independent producer, but also the dozens of financial and commercial partnerships they have built worldwide to secure financing for each film.

Despite statements to the contrary from proponents of these schemes, most independent pictures would not be the subject of proposed contracts because the picture will not meet the criteria such as a simultaneous release in 600 or 650 U.S. theaters. Moreover, most independent films are first theatrically distributed in the U.S. and are released by the MPAA studios which control the marketing and release plans including determining what type of a release (*i.e.,* limited, platform, wide) will launch a motion picture; the independent producer does not control the factors on which these exchanges base qualifications. Even in the event that the independent

[1] For a complete list of IFTA Members, visit *www.ifta-online.org.*

picture meets such criteria, since independent producers must pay back production loans based largely on foreign revenues which are earned after the U.S. theatrical release and could be harmed by negative publicity, they are unlikely to engage in hedging that could jeopardize their previously established financing and distribution relationships.

Further, these proposed contracts may not appeal to independent producers as a risk management tool since independent producers already exercise risk management in their financing and distribution models by securing pre-production commitments from foreign distributors worldwide known as "minimum guarantees." Those minimum commitments by foreign distributors along with any government incentive programs are collateralized by financial institutions and other investors which loan the producer the production budget. The financial institution or other investors are granted an assignment of the copyright in the motion picture until the production loan is paid back.

Any hedging by the U.S. distributor (again, a separate company which is not affiliated with the independent production company) could harm the long term prospects for a picture's worldwide distribution. Since only about 18% of worldwide sales revenue is derived from U.S. distribution and only a portion of that from U.S. theatrical distribution, independent producers must rely on the proceeds of foreign distribution to pay back the production loan and other investors and so are unlikely to hedge on the U.S. theatrical release. The existence of such schemes would place independent producers in the difficult position of assuring their overseas distributors that the foreign revenues will not be jeopardized by the U.S. distributor, but could never guarantee that hedging would not occur or negatively impact the long term potential of the Picture.

"Split rights" deals in which one company controls U.S. distribution and another company takes foreign rights are common in the industry. A market that allows hedging on the domestic side creates significant risk of harm to the company controlling the foreign rights and damages the long term prospects for the picture. In the case of split rights licensing arrangements in which an MPAA studio control exclusive U.S. distribution rights, and another studio, or in the case of independents, a network of distributors control the exclusive foreign distribution rights, any hedging by the U.S. distributor could critically damage the picture's foreign distribution rights. Any negative publicity will disproportionally harm independent producers and their foreign distributors, who are unlikely to avail themselves of U.S. based hedge funds.

Any such exchange requires that insider knowledge and trading be controlled in order to ensure integrity of market. Compliance compatible with such controls may be impossible in the worldwide reaches of the independent motion picture industry due to the sheer number of potential insiders. Since many times foreign distributors are investors in a picture prior to production and release, potential insiders could be spread worldwide preventing enforcement of insider manipulation or trading. Approval of the proposed contracts also will require MPAA studios, independent production companies and all other industry participants that have the power to affect futures pricing to institute anti-insider trading compliance regimes for the proposed contracts and this may ultimately impact the MPAA studios relationship with independent producers to supply programming. In the event that the studio is distributing an independent picture, the potential for many more insiders outside of the studios' control is enormous. There are many industry participants who have access to material, non-public information and could try to use that information to profitably bet on the proposed contracts.

Futures prices also are susceptible to manipulation by false market rumors. "Hollywood" is referred to as a "company town" and there is no shortage of media and speculation about this industry's main product—motion pictures. There already are plenty of rumor mills with respect to the quality of motion pictures and many taking place online. In this environment it would be impossible to identify the sources of such rumors or to prosecute any alleged manipulation by false rumors, because such rumors would typically be based on opinions relating to a motion picture's artistic or entertainment merit rather than verifiable facts. What was once industry "talk", idle gossip or opinion could have a more profound impact on our creative industry. For the independent industry and its worldwide participants, there is no effective way to reliably determine the source of such rumors. It also remains unclear what legal duties and liabilities apply and for whom if the base data fails to fully report or gather accurate data or if a studio makes an inaccurate announcement of receipts. If an independent motion picture is subject of a proposed contract and manipulation is asserted, defending such suits would be financially devastating for an independent producer.

It is for the reasons stated in this Written Statement and in the Coalition's Written Statements that IFTA opposes such proposed contracts. Thank you once again for the opportunity to outline the critical concerns of the independent motion picture industry in connection with these proposed contracts. IFTA respectfully urges that they be denied.

SUBMITTED STATEMENT BY DON M. CHANCE, PH.D., C.F.A.; ON BEHALF OF CANTOR FITZGERALD

My name is Don M. Chance and I am Professor of Finance and holder of the James C. Flores Endowed Chair of MBA Studies at Louisiana State University. I have been asked by Cantor Fitzgerald to provide a statement and document to the United States Congress that would support its request for approval of a new futures exchange in which contracts would be based on the box office revenues of movies. While I am being compensated for my service, I had independently established this opinion as evidenced by my co-authorship of two articles over the last two years on a similar financial instrument. In the spirit of full disclosure, I provide the caveat that these remarks are my own and do not necessarily represent the views of my employer, Louisiana State University.

Qualifications

I hold a Ph.D. in finance from Louisiana State University and am a CFA (Chartered Financial Analyst) charterholder. I have been an internationally recognized scholar and consultant in the area of financial derivatives for nearly 30 years. I formerly taught at Virginia Tech, and I have authored three books on financial derivatives, including one widely-used textbook currently in the 8th edition, and another that is the required reading for the CFA examination program, which is taken by over 120,000 candidates worldwide each year. I have authored nearly 100 published articles, most of which deal with derivative instruments. I have conducted training programs for UBS, Thomson Financial, The German Society of Financial Analysts, the International Federation of Banking of Luxembourg, Goldman Sachs, and the World Bank. I am an advisor to IndexIQ, a New York-based creator of exchange-traded funds, and to The Governance Fund, a Minnesota-based investment advisor. Prior to my academic career, I spent four years in commercial banking.

My specific qualifications for this matter derive from two articles I co-authored. The first, "Pricing an Option on Revenue from an Innovation: An Application to Movie Box Office Revenue," was published in 2008 in *Management Science* (Vol. 54, No. 5, pp. 1015–1028), a prestigious interdisciplinary scholarly journal with extremely high publication standards. The second paper, which extended some of the work in the first paper and was targeted more toward practitioners, appeared in *Risk* magazine (Vol. 22, May, 2009, pp. 80–86) and was entitled "Pricing Options on Film Revenue." Both of these articles were co-authored with Professors Eric Hillebrand of Louisiana State University and Jimmy Hilliard of Auburn University.

These two papers emanated from a long-term interest I have had on how the entertainment industry has pursued means of hedging the significant risk it faces in the music and films it produces. I will provide a brief review of this subject in this document. The papers demonstrate how to capture the statistical properties of revenues from a movie and how to use that knowledge to create options that would pay off based on how a movie performs. Although the instruments being proposed by the new exchange are futures contracts, the essential characteristics of options and futures are sufficiently similar such that any differences in the context of this matter are trivial.[1]

This statement will be followed by a white paper at a later date (see *Attachment*).

Futures Markets and Contracts as Regulated Risk Management Tools

Futures markets have operated successfully in the United States since the middle of the 19th century. They provide a facility for the trading of standardized contracts to buy and sell a specified underlying asset at a fixed price at a future date. Com-

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[1] By way of clarification, an option enables a party to claim the value of an asset or the payoff of an asset by paying a fixed amount of money at a certain date. For this right, the buyer pays a fixed sum of money, the option price, at the start to the counterparty or seller. The counterparty/seller receives the up-front payment from the buyer and must be willing to provide the payment or asset demanded by the buyer, if the buyer so chooses. A futures is an agreement in which one party commits to claiming the value of an asset or the payoff of an asset by paying a fixed price at a certain date. The counterparty, or seller, in a mirror image, agrees to deliver the asset or pay the value of the asset to the buyer on the given date. Whereas an option is a *right* held by the buyer and granted by the seller, a futures is an *obligation* on the part of both buyer and seller.

monly traded assets are stocks, bonds, currencies, metals, energy, and commodities. The market is used extensively by various parties to transfer risk and adjust their wealth exposures to levels that are suitable for their risk tolerances. Futures markets provide an absolute credit guarantee that is enabled by the existence of a clearinghouse that stands between each party to a futures contract and guarantees payment to the party that profits that it will pay if the party that loses defaults. Clearinghouses have existed since around the 1920s, and no party has ever suffered a credit loss from failure of a clearinghouse. In my opinion futures markets have performed exceptionally well during periods of market stress. In particular, during the crash of October 19, 1987, on which U.S. stocks lost nearly a fourth of their value a single day, U.S. futures markets led the rally that stopped the carnage.

Futures markets exist alongside other markets for similar instruments, some of which trade in standardized regulated markets and some of which trade exclusively in the largely unregulated over-the-counter market. Options, for example, which can often be used with or in place of futures, exist in both exchange-traded markets and over-the-counter markets. Swaps and forwards, which are even more closely related to futures, trade only in over-the-counter markets. These instruments are part of the larger family of instruments called derivatives. As noted, they are often substitutable and their existence and use is nearly always for similar purposes.

Futures markets are regulated by the United States Commodity Futures Trading Commission (CFTC). In its history, the Commission has approved over 700 futures contracts. The CFTC has tended to take the view that futures contracts should be allowed to be offered and succeed or fail on their merits. Futures exchanges are highly competitive and aggressively compete by offering similar products. A sign of a healthy market is a low success rate and indeed U.S. futures markets are healthy. My research has shown that only about one in four new contracts is successful.

A Market for Futures Contracts on Movie Revenues

Cantor Fitzgerald has proposed a new type of futures contract, one in which traders would enter into agreements to pay a fixed sum of money for the right to receive a variable sum of money that would be determined by the financial performance of a movie. These "movie futures" are, in my view, long overdue and should be permitted. There is a long history of discussion about this type of instrument and indeed, the film industry itself has a track record of attempting to create similar instruments. Regardless of what views have been conveyed by the entertainment industry on the matter of this new proposed exchange, it is apparent that this industry is interested in means of shedding some of its risk.

Based on my research, I believe the first such effort was the issuance of a $400 million, 7 year bond by the Walt Disney Company in 1992. This bond specified that the interest would be determined by the revenues from a package of 13 movies to be released in Europe. Hence, Disney was laying off some of the risk of the performance of these movies to the investors who bought the bond. In 1997, Pullman LLC offered what came to be known as the famous "Bowie Bonds," a $55 million issue purchased by Prudential in which the interest payments were determined by David Bowie album sales. Similar bonds have since been offered based on royalties generated by James Brown, the Isley Brothers, the songwriting teams of Ashford and Simpson as well as Holland, Dozier, and Holland, and by revenues from movies of Dreamworks SKG. Many of these instruments are created through a process known as securitization, whereby investors can obtain equity returns as well as interest payments. Thus, the entertainment industry has clearly indicated a desire to eliminate some of its risk.

There appears to be considerable demand on the part of investors for opportunities to trade derivative instruments based on film revenues. This interest is fueled by two factors. One is that professional investors are constantly looking for new opportunities in asset classes that have little to no correlation to the more conventional asset classes, such as stocks, bonds, and real estate. This lack of correlation improves the efficiency of investment portfolios, leading to higher expected returns for a given level of risk. Movie revenues are indeed the very type of asset class that appeals to such investors. As my research shows, movie revenues have virtually no correlation with the stock market.

The second factor is the sheer interest in movies. One of the important characteristics for the success of a futures contract is that there must be a significant interest in the asset or value on which the contract is based. Movies are not only appealing for their entertainment value, but the financial performance of a movie is a much-watched statistic to many Americans. Each week, a news story discusses how new releases did over the weekend. There are several successful websites that track the performance of movies and the revenue generated by stars. While the performance of a movie is probably not as widely followed as sports scores and the stock market,

it does, nonetheless, garner considerable attention, which passes the litmus test of a successful futures market—there must interest.

Discussions of the creation of exchanges for standardized trading of financial instruments based on entertainment revenues have a long history but little success to date. There has been far more talk than action, and none appear to have been structured within the regulated environment of futures markets. The Cantor proposal, set up within the U.S. regulatory structure, is the first one I believe that has a reasonable chance of success. And if it is not successful, movie revenue futures will go the way of the 75% of other futures contracts that were launched and failed. That is the American way.

I understand that the film industry objects to the Cantor proposal. I believe it has expressed the view that it is not likely to use these contracts to hedge. I respectfully disagree, based on my observations that the entertainment industry has for many years sought means of laying off this kind of risk. It may well take some time, but I believe the industry will warm up to this product. In particular, the independent film makers who do not have access to the tremendous resources of the major studios could make substantial use of this contract. Providing these small companies with such opportunities would help them be more competitive with the larger studios. This could also have the effect of stimulating more independent film production, which can only be good for the American public. If the industry ultimately does fail to use it, however, it is unlikely that this new exchange will be successful. The losers will be only Cantor Fitzgerald. In my view, Cantor should be allowed to try and if it cannot make a success, it should fail. That is how we do it in this country and indeed that is what makes America great.

The industry has also opined that no one is likely to buy these contracts, inasmuch as it sees no party that would be harmed by outstanding performance of a movie. It seems to me, however, that parties that negotiate DVD and television rights, the rights to manufacture and market other products with tie-ins to movies and characters, and international distribution rights would be buyers. Better performing movies are far more expensive to these parties, and they could greatly benefit from the use of these futures to keep their costs more predictable, which is the main benefit of hedging.

The industry has also argued that the data on which payoffs are made is subject to manipulation. I find this a rather strange response for two reasons. It is as if a company objects to the trading of derivatives on its stock because the company could manipulate the financial information it releases. Moreover, if the industry would manipulate its own data, it sounds like an admission that the industry would use the contract. But in any case, financial regulations permit trading of derivatives on the company's stock, whether the company objects or not. If the data are subject to manipulation, it is almost surely no more than the manipulation that is possible by corporations operating within Generally Accepted Accounting Principles. This leads to my last reason for wanting to see this contract.

I suspect the industry does not want financial analysts and professional investors studying the finances and accounting for movies. I believe, however, that the financial industry can serve a valuable public purpose in bringing more transparency to the film industry. Perhaps the data are already being manipulated. Manipulation will be harder if financial analysts and professional investors are watching over the industry, as they will if these futures contracts are allowed to trade. Thus, this new market can help improve the quality of the information that originates from this industry.

Conclusions

I urge the United States Congress to grant the petition of Cantor Fitzgerald to create this new futures market. Your concern should be what is good for the public and in that regard, I see no real risk to the public. Cantor Fitzgerald is not large enough to present a systemic threat, and this project is not large enough that its failure would destroy the firm. Therefore, if this exchange fails, the only losers are the owners of Cantor Fitzgerald.

There is yet another reason why this Congress should approve this proposal. I suspect that if we do not allow this kind of market in the regulated U.S. futures environment, it will create itself either within the unregulated over-the-counter market, as it has done on a small scale already, or it will be created and succeed overseas. With almost all of the successful movies being produced in this country, it would be quite a shame if movie futures markets exist only in foreign countries.

ATTACHMENT

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The Potential Effects on the Movie Industry of Futures Trading on Film Revenues [1]

I. Executive Summary

This report addresses the key questions that have recently been raised about the introduction of a contract such as the proposed Domestic Box Office Receipt (DBOR) futures instrument and the associated Cantor Exchange. The report has three key components that address this important issue from several perspectives.

First, using classic financial principles that describe what effective futures contracts and financial markets should contain, I find that the DBOR contract and Cantor Exchange meet these criteria and thus this contract market represents a legitimate and effective vehicle to conduct futures trading in the area of first-run movies. In addition, the role of speculators within a futures market is clarified using the U.S. Commodity Futures Trading Commission's (CFTC) own description of these market participants. Contrary to some of the recent media coverage, speculators are not "gamblers" or "evil" and thus these investors provide a useful economic role in ensuring liquidity and greater price transparency within a futures market.

Second, this report also demonstrates how the introduction of a DBOR market can benefit not only the direct participants in such a futures market but also help other players in the movie industry such as consumers and the movie studios. The main benefits of introducing a DBOR futures market are:

(1) Better risk management for investors and other participants in the movie business,

(2) Increased new investment in the movie industry from current film investors,

(3) Additional investment from new investors that are now attracted to the film industry, and

(4) Greater transparency which yields useful price signals for the entire economy.

The report also examines two potential costs of such a market related to the possibility of market manipulation and/or insider trading. However, the financial incentives of the Cantor Exchange and the clear mandate of the CFTC to ensure that futures markets are fair to all participants indicate that both of these organizations have the proper motivation to actively employ the necessary surveillance and enforcement systems in order to mitigate the possibility of market manipulation and/or insider trading.

Lastly, this report also reviews the academic literature on this subject and I find that there is both sound financial theory and solid empirical evidence that support the notion that the benefits of introducing a futures market can greatly outweigh the potential costs noted above. Empirical evidence over the past two decades not only in the U.S. but also more recent evidence from numerous countries around the world confirm the positive effects of introducing a futures market in terms of increasing price transparency, providing better risk management, reducing price volatility, and increasing the liquidity of financial markets.

II. Introduction/Background

This report examines the potential benefits and costs associated with introducing a set of futures contracts based on the revenues of a first-run movie's initial 4 week box office revenues. To begin, it is helpful to review the classic principles that underlie all effective financial markets and futures contracts. In addition, this section explains the fundamental role that traders who are not hedging an underlying exposure (typically referred to as speculators) can play within a properly functioning financial market.

Key attributes of a financial market:

There is a well-established set of academic literature on the role of financial markets within an economy. In particular, seminal work by Hayek (1945), Debreu

[1] *To better inform those parties interested in understanding the role of futures trading on first-run movies, Cantor Exchange, Inc. commissioned the author to write this report describing the new potential market for enabling investors to manage risk and trade these new contracts. This article presents my analyses and opinions only and does not necessarily represent the opinions of the sponsor of this project. The author retained full editorial control over the content and conclusions of this report.*

(1959), and Arrow (1964) show that an effective financial market can serve two economically important functions: (1) the market can help investors allocate and share risk via trading and hedging activities, and (2) the market can communicate, via public disclosure of price and volume data, important information about the value of financial securities to all members of society (not just the counterparties to the transaction). This latter function is extremely useful because all participants in the economy (not just the specific financial market) can use these price and volume data as signals of the relative supply and demand for the relevant securities which, in turn, allows all members of society to make more informed economic decisions.

Given the proposed market structure of the Cantor Exchange, it meets the above criteria of an effective financial market because it will: (1) allow investors to hedge their exposure to the financial performance of specific movies, and (2) provide 24/7 trading opportunities and real-time reporting of transactions via a web-based data dissemination service. Thus, investors in this exchange will be able to trade, hedge, and observe the price and volume activity in a transparent manner.

Key attributes of a futures contract:

For a futures contract to be a viable, effective tool for risk management and trading, it should have the following qualities:

- An objectively verifiable "commodity" that is to be traded (*i.e.,* the contract's value can be independently and objectively determined by market participants).
- Standardized terms (documentation that states exactly what is the amount of the contract, expiration months, last trading day, settlement procedures, *etc.*).
- Clearing mechanism (a clearinghouse reduces counterparty credit risk and improves price transparency so that all market participants can observe the prices and quantities of the contract that have been traded on a daily basis).
- Margin system (this enables all futures positions to be marked to market on a daily basis and thus reduces the overall counterparty credit risk within the clearinghouse and between the rest of the market participants).
- Low transaction costs (this encourages greater trading activity and thus higher levels of liquidity that benefit all market participants).
- Open, easy access to the futures market (by permitting direct access to the market for all investors, the market's liquidity can be maximized).

The DBOR futures contract, as proposed by the Cantor Exchange, Inc., meets all of the above criteria for a futures contract.

The role of speculators in a futures market:

Although the popular press and other parties might portray speculators in the futures markets as "gamblers" or "evil," the economic and financial reality is that speculators play an important role within a futures market (see *Appendix 1* for some brief excerpts from recent media coverage of this issue). In particular, speculators provide much-needed liquidity to the market by, for example, taking the other side of a transaction in which a person wants to hedge. For example, a consumer of corn such as a cereal producer might want to hedge against increases in the price of corn and thus might want to buy corn in the futures market. If there is no one who owns corn (such as a farmer) who is willing to sell corn in the futures market, then the speculator can step in and play an key role by selling the corn on speculation that the price will fall. The speculator's trade enables the cereal producer to hedge its position and thus help this firm manage its risks more efficiently.

In fact, the CFTC itself recognizes this important role that speculators play, as shown by the following excerpt from their web site (*www.cftc.gov*):

> **The Role of the Speculator**
>
> A speculator is one who does not produce or use a commodity, but risks his or her own capital trading futures in that commodity in hopes of making a profit on price changes. While speculation is not considered one of the economic purposes of futures markets, speculators do help make futures markets function better by providing liquidity, or the ability to buy and sell futures contracts quickly without materially affecting the price. Long and short hedgers may not be sufficient to create a liquid futures market by themselves. The participation of speculators willing to take the other side of hedgers' trades adds liquidity and makes it easier for hedgers to hedge.

In sum, using the fundamental criteria noted above that define what effective futures contracts and financial markets should possess, I find that the DBOR contract and Cantor Exchange meet all of these criteria and, accordingly, create a valid means of providing both hedgers and speculators with an effective way to conduct

futures trading in the area of first-run movies. The above discussion also dispels the belief that speculators are inherently bad for a financial market and the economy in general.

III. The Main Benefits and Costs of Film-Related Futures Contracts

Film-related futures contracts have four main benefits and two potential important costs, as noted below.

Benefit 1. Better Risk Management for Investors and other Participants in the Movie Industry

When discussing the role of a futures contract such as the Domestic Box Office Receipt (DBOR) contract, it is most important to keep in mind the hedging, or risk management, feature of these contracts. The use of DBOR futures allows existing parties with material investments in the success of a movie to hedge their risks (*e.g.,* not only the financial investors in the film but all of the movie theater operators around the world can be at risk of having a large number of empty seats in their theaters if a film is unsuccessful). Thus, there is a genuine need for these investors to hedge some of the risk associated with their investments in time, money, and other resources associated with a specific movie.

Retail consumers of movies could also benefit by participating in the market for DBOR contracts. For example, if their trades in this market are profitable, then this can offset the cost of purchasing movie tickets, DVDs, and other movie-related goods and services. This type of interest on the part of retail consumers could also spur greater consumption of movies, DVDs, *etc.,* as these individuals might be more interested in going to additional upcoming movies that they would not have otherwise been aware of.

Benefit 2. Stimulates New Investment from Current Investors in the Movie Industry

By enabling both large film investors/financiers and theater operators to hedge in the DBOR market, another benefit is created, namely, this hedging capability can stimulate additional investment from these existing participants in the movie business. Thus, by using DBOR futures to hedge, say, half of a film investor's investment in one movie, this investor could then invest in a second, additional movie and hedge half of his/her investment in this second film. In this way, the investor can invest in two movies for the same amount of net risk exposure as he/she would have normally done for one movie when there was no DBOR market. Consequently, more investment capital can be provided by current film investors/financiers to the movie studios that produce these films. So, both investors and the movie studios can benefit through the increased amount of capital available for investment in the movie industry. Consumers who purchase movies can also benefit from this additional investment if the movie studios produce films of greater quality, quantity, and variety.

Benefit 3. Attracts Additional Investment from New Investors to the Movie Industry

Another side benefit of an active DBOR futures market is that a "positive externality" can exist between this futures market and potential new film investors and theater operators.[2] For example, the hedging and trading activities of existing investors and theater operators can have a positive effect on individuals and firms that are not currently involved in the film business. The economics of positive externalities, sometimes referred to as "network effects," indicates that the creation of an active DBOR market can encourage new investors and other firms to become interested in investing in the movie business (either by investing directly in first-run movies, building new theaters/DVD stores, or trading in the DBOR market).

In the past, these investors and firms might have been interested in the movie business but deemed it too risky to invest in. However, these potential participants may now invest in the movie industry because the DBOR contract provides these players with a cost-effective way to mitigate some of their movie-specific risk. This will have the positive effect of stimulating greater investment in not only first-run movies but also the entire movie business infrastructure (theaters, stores, rental kiosks, *etc.*). In turn, this can help stimulate employment in various areas such as the film studios, theater operators, DVD rental stores, and even the construction industry to some extent.

[2] A "positive externality" is a benefit that some individuals or firms receive without paying the full cost for this benefit due to the economic activities of other unrelated parties. For example, if two people own cell phones, then a third person can benefit by calling these individuals even though he/she might not own a cell phone. In turn, the benefit to this third person for purchasing a cell phone might be greater than the phone's cost because he/she can now call several other people in a more convenient way.

Benefit 4. Greater Transparency yields Useful Price Signals for the Entire Economy

By developing an active DBOR market, not only do the market participants benefit from the greater "price discovery" created by trading this futures contract but also non-participants can benefit because they can use the transaction price and trading volume data as useful "price signals" about the anticipated supply, demand, and growth prospects for various films.[3] This information, for example, can be useful to a movie studio which does not even participate in the DBOR market because the price and volume data from this market can help the studio decide to invest more in, say, 3D movies because the DBOR futures market might be showing strong price gains for contracts related to current 3D films. By monitoring prices and volume in the movie futures market, the relatively scarce economic resources of any one film studio can then be allocated in a more efficient manner. This, in turn, benefits the entire economy because better price and volume signals from the futures market can lead to more effective investment decisions by studios, theater operators, retail DVD stores, and consumers. Given the relatively flat/stagnant trend in movie box office receipts and ticket sales over the past decade, the ability to make better investment decisions should help stimulate growth and innovation in the U.S. movie industry (see the table in *Appendix 2* for more details).

Potential Cost 1. The Possibility of Market Manipulation

The biggest "cost" (as opposed to benefit) of the proposed DBOR futures contract is the possibility that the market could be manipulated by one or more traders for their personal gain by artificially pushing prices up or down and then profiting from a sudden reversal in prices. In any market (not just futures contracts) where there is low liquidity, this risk is present. The key to minimizing this risk and lowering the potential "cost" associated with DBOR futures trading is through diligent monitoring and active enforcement of the rules established by the CFTC and the Cantor Exchange itself. Otherwise, investors will not want to trade on an exchange where it is perceived that prices are easily manipulated and thus the market is "rigged" against these investors.

Since the Cantor Exchange has a strong and direct incentive to maximize the DBOR market's trading volume and the CFTC's role is to ensure that all futures markets are fair to all investors, both of these parties are motivated to ensure that the participants in the DBOR market are acting in a responsible and fair manner. Thus, the Cantor Exchange has set up monitoring/surveillance systems which can thwart the efforts of potential price manipulators and ban them from the trading system. In addition, the CFTC has its own sophisticated surveillance and enforcement systems and staff which will be monitoring the trading activity in the DBOR market and can impose severe penalties for those parties that attempt to distort market prices.

Potential Cost 2. The Possibility of Insider Trading

Another potential cost associated with not only the proposed DBOR futures market but any financial market is the problem related to insiders trading on material, non-public information. For example, some have voiced concern that employees of film studios, studio sub-contractors, or other individuals would exploit their inside information about the prospects for a film via the DBOR futures market. However, this problem is no different than the problem faced by the employees of a large consumer of corn (*e.g.,* a cereal maker) or the corn farmer himself, for that matter, who potentially has inside information on the supply and demand for corn which could be exploited in the corn futures market. Thus, the CFTC has decades of experience dealing with this issue and has demonstrated that it can effectively monitor this issue to ensure a fair and level "playing field" for all futures market participants. In addition, the Cantor Exchange itself has strong financial incentives to ensure the DBOR market is one of high integrity.

In sum, the four primary benefits noted above are quite powerful while the two potential costs can be properly mitigated by effective surveillance and enforcement systems operated by both the Cantor Exchange and the CFTC. Overall, the main benefits described above appear to clearly outweigh the potential costs associated

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[3] By "price discovery," I mean the process by which traders submit orders to buy and sell in order to identify the "true" equilibrium price for the security (*i.e.,* where supply equals demand for a film's expected revenues). Interestingly, it could be that the film studios are concerned that they will lose their monopoly position on this price discovery process because information about various movies will be published by the futures exchange which *all* market participants can then observe and analyze. This is the type of information that is currently held privately by the film studios and thus some of these firms might be concerned with losing their informational edge to non-Hollywood participants in the futures market.

with introducing the DBOR futures contract. Next, I turn to the academic literature to see what effect prior introductions of derivatives markets have had on existing financial markets. This review of both finance theory and empirical evidence can help inform us about how the introduction of the DBOR market might affect the movie industry in the future.

IV. Review of the Relevant Literature on the Impact of Introducing a Derivatives Contract into an Existing Financial Market

Theoretical Models of Derivatives Introduction

Given the above discussion of the key features of well-designed financial markets and futures contracts, as well as an assessment of the key benefits and costs of introducing the DBOR contract, it is instructive to review the relevant theoretical and empirical academic literature. In this way, one can see how prior introductions of derivatives contracts have affected the efficiency of an underlying "cash" market (also referred to as a "spot" market). By doing so, one can gain greater confidence regarding how the introduction of the DBOR contract could affect the existing market for first-run movies.

Although, strictly speaking, there is no cash, or spot, market for the secondary trading of movie tickets, there is clearly a large market for the primary sale of movie tickets by theater operators.[4] That is, there is no active market for consumers to trade movie tickets amongst themselves in a secondary market but, as the table in the *Appendix 2* shows, there is a $10 billion annual market for the primary sale of movie tickets by theater operators. Thus, one can view this market as a primary "spot" market for movie tickets.

Initial theoretical work on the impact of derivatives contracts on underlying cash/spot financial markets builds upon the seminal work by Kyle (1985). In Kyle's model, asymmetric information is present in the financial market, which meant that some traders have better information (*i.e.,* they are "informed" traders) while others have less information (they are described as being either "uninformed" traders or serving as a single "market maker" in the financial asset).

The above issue of asymmetric information is an important attribute of a real-world financial market because it is clear that some traders are more sophisticated and better-informed about the future value of a security (*e.g.,* mutual fund or hedge fund managers) than other traders (*e.g.,* small retail investors and market makers). Since informed traders, by definition, know more than the uninformed traders, the less-informed traders will typically lose, on average, when they trade with their better-informed counterparts. Since an uninformed trader such as a market maker knows this, this person will try to infer the presence of informed traders by carefully observing the flow of orders submitted to the financial market.

Based on the Kyle model, the bottom line is that asymmetric information can lead traders to behave strategically and can ultimately affect the pricing of financial assets, as well as the trading volume and price volatility associated with these assets. In general, investors will typically pay less for an asset if it is traded in a market with high levels of asymmetric information and uninformed investors are also less likely to participate or trade in such a market. The practical implication of the model is that well-designed financial markets such as the Cantor Exchange's proposed DBOR market can reduce the problems associated with asymmetric information by promoting greater price transparency and increasing the public disclosure of information related to the financial asset. In turn, this can lead to greater liquidity, lower price volatility, and greater trading volume in both the futures and cash markets.

Building upon Kyle (1985), research articles such as Grossman (1988), Detemple and Selden (1991), Subrahmanyam (1991), Jarrow (1994), Huang and Wang (1997), and Cao (1999), among others, examined how asymmetric information and traders' strategies are affected when a derivatives market is introduced for a corresponding spot market. In addition, without relying on an asymmetric information model, Silber (1985) shows that a futures market can potentially enhance the efficiency of a spot market by enabling market makers in the cash asset to hedge more effectively.

By focusing on the hedging capabilities of a derivatives market, Grossman (1988) demonstrated that the introduction of a derivatives contract can help people aggregate all information related to investors' hedging strategies which can then reduce

[4] A primary market is one where a security is sold for the first time such as the initial public offering (IPO) of common equity in a new company. A secondary market is one which trades securities that have been previously issued. In addition, a "cash" or "spot" market is one in which an investor can purchase or sell a security today (as opposed to sometime in the future, as in a futures market).

the level of asymmetric information in the overall market. In turn, this reduction in asymmetric information can reduce the price volatility of both the derivative contract and underlying cash asset.

Detemple and Selden (1991) examine how the introduction of a call option market can increase the underlying price of the cash asset due to the simultaneous pricing of both the call option and this cash security. Cao (1999) examines the incentives to collect information on the underlying cash asset and finds that investors have greater motivation to gather this information and thus cash prices are higher and volatility is lower when a derivatives market exists. In general, all of these models suggest that the introduction of a derivatives market can be positive in terms of raising the value of the cash security and reducing price volatility. In addition, a side benefit of these two positive effects is that it encourages more investors to participate in these markets, thus making them more liquid and efficient. Thus, a "virtuous" cycle between the derivatives and cash markets can be created due to the above effects.

In contrast to the above models, Subrahmanyam (1991), Jarrow (1994), and Huang and Wang (1997) cast a more ambiguous light on the effects of a derivatives market. For example, Subrahmanyam (1991) compares the introduction of a stock index futures market to the cash market for the securities that comprise this stock index. The author's focus is on where discretionary traders choose to trade. In the model, there are some traders who have discretion over where and when to trade and thus these individuals face a choice of whether to trade in the cash or derivatives markets.

The model suggests there is a trade-off between trading in the index futures market where there is potentially less asymmetric information (because a stock index will diversify away some of this information-related risk) and the cash market where there might be greater liquidity (because larger, informed traders might prefer to trade in this market). Thus, the model shows that the effect on the underlying cash asset's price is ambiguous and is dependent on the discretionary traders' choices based on the above trade-off. For example, if the discretionary traders all send their orders to the derivatives market, the liquidity in the cash market might dry up and cause the cash price to fall and become more volatile. Conversely, if these traders choose to route their orders to the cash market, then cash prices will be higher and volatility lower. In this context, it is ultimately an empirical question as to which effect dominates.

Huang and Wang (1997), using a different theoretical framework, come up with a similar conclusion in that the incentives to collect information are greater when a derivatives market is present but this positive effect is counter-balanced by the fact that increased levels of trading activity can result in noisier price signals in the cash market. Thus, once again, the question of which effect is predominant becomes an empirical one.

Jarrow (1994) approaches the problem from a different perspective by examining an investor's incentives to manipulate prices when an options market is introduced for an underlying cash asset. The model demonstrates that investors might try to manipulate prices to take advantage of arbitrage opportunities between the cash and options markets. However, Jarrow (1994) also proves how this type of manipulation can be easily avoided by applying a properly specified variant of the conventional binomial option pricing model. Thus, by using the appropriate option pricing model, the author shows that the incentives to manipulate prices can be effectively eliminated.

Summing up the theoretical literature, one can see that all of the models explain how the introduction of a derivatives market such as the DBOR futures contract can improve the welfare for society by providing more accurate price signals about the supply and demand for the underlying cash asset, as well as by reducing price volatility and increasing market liquidity. However, as noted above, some theoretical models indicate that there may be a trade-off between these benefits and other factors such as the decisions of discretionary traders and the level of trading activity in the underlying cash market. Accordingly, I now turn to a review of the relevant empirical literature to see which effects are dominant in real-world financial markets.

Empirical Tests related to Derivatives Introductions

Early empirical research related to the effects of derivatives contracts on cash financial markets typically focused on how the introduction of a futures contract on a stock index such as the S&P 500 affected the price volatility of the underlying cash market for the 500 stocks that were actively traded in secondary markets such as the New York Stock Exchange (NYSE) and NASDAQ. In general, this initial research showed that futures markets can increase trading activity but the effect on

price volatility is somewhat muted except on the expiration day of the futures contract (and even then, the increase in volatility is short-lived, *e.g.,* within one trading day). For example, Stoll and Whaley (1987, 1988), Edwards (1988), and Harris (1989) all study the S&P 500 futures contract and its impact on the cash market for the stocks that comprise this index.

Edwards (1988) finds that stock price volatility has been lower since the introduction of stock index futures contracts while Harris (1989) observed no economically significant change in volatility. In contrast, Stoll and Whaley (1987) document that trading volume and price volatility can increase at the time of the futures contract's expiration but this effect is temporary and is actually less than the impact of a typical "block trade" in the underlying cash market.[5] In a follow-up article, Stoll and Whaley (1988) summarize the important role that a financial market (in this context, a market for stock index futures) can play in terms of communicating relevant information to all members of society: "Financial markets serve as the economy's messenger. . . . Index futures expand the number of routes through which messages can travel."

Overall, the early empirical evidence based on U.S. markets supports the notion that price volatility and trading volume in the underlying cash market can be affected but not in an economically significant way during normal market conditions. Thus, this initial strand of the literature suggested that, on average, the effect of introducing a futures market on stock prices was neutral in that it created neither unusually greater nor lower volatility.

After the first wave of empirical studies during the mid to late 1980s, more sophisticated empirical tests were performed during the 1990s and the most recent decade. For example, Detemple and Jorion (1990) find significant positive support for Grossman's (1988) prediction that the introduction of options can increase underlying stock prices and reduce volatility. In contrast, tests of Subrahmanyam's model in Jegadeesh and Subrahmanyam (1993) show an economically *insignificant* increase in the average proportional bid-ask spread for a set of stocks that included the securities that comprise the S&P 500. The authors also report an insignificant increase in level of asymmetric information within the cash market. In general, these relatively insignificant results indicate that the S&P 500 futures market does not harm the cash market for S&P stocks and thus provides neutral, or mixed, evidence in support of the positive effects espoused by many of the theoretical models noted above.

Easley, O'Hara, and Srinivas (1998) examine the market of stock options in the U.S. to determine the informativeness of this derivatives market *vis-à-vis* the underlying cash market for these stocks. Consistent with the theories that show a positive role for derivatives markets such as Grossman (1988), Detemple and Selden (1991), and Cao (1999), Easley *et al.* (1998) report that option trading volume can be a leading predictor of cash stock prices. The authors conclude that this result could be due to the possibility that informed traders prefer to trade in the options market and thus these option traders' actions help reveal useful information that can enhance stock prices in the cash market for all investors.

Most notably, Hasbrouck (2003) studied the market for the S&P 500 stock index by analyzing which of the following cash and derivatives markets contributed the most information to setting prices for the cash value of this index (*i.e.,* floor-traded index futures contracts, exchange-traded funds (ETFs), electronically traded, small-denomination futures contracts (E-minis), and sector ETFs that sub-divide the index into sub-industry portfolios). The author finds that the S&P 500 index (as well as the Nasdaq-100 index) receives its most informative price signals from the E-mini futures market.

The above empirical finding is another important example of the positive benefits associated with the introduction of a futures market that were predicted by the theoretical models of Grossman (1988), Detemple and Selden (1991), and Cao (1999). It is also particularly striking that the smaller E-mini futures market leads the way in terms of setting prices in the market because these contracts were specifically designed to attract smaller, retail investors who cannot generally afford the larger, more expensive floor-traded futures contract. Thus, the results are also consistent with Subrahmanyam's model because the evidence suggests the positive effects of trading with a futures contract outweigh the potentially greater liquidity in the cash market (and so even retail investors prefer the futures market over the cash market in this case). In turn, this suggests the positive effects of introducing a futures market dominate the potential negative factors of such a market.

The results of Hasbrouck (2003) have also spawned somewhat of a global search to see if Hasbrouck's findings can be replicated in other, non-U.S. markets where

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[5] A "block trade" is typically defined as a trade of 10,000 shares or more in a single stock.

futures contracts have been introduced. For example, Illueca and Lafuente (2008) applies Hasbrouck's approach to a foreign market which introduced a retail-oriented stock futures contract. Specifically, the authors examined the effect of introducing the Ibex 35 mini-futures contract in the Spanish stock market. By allowing retail investors to participate more actively in the futures market for this Spanish stock index, Illueca and Lafuente find prices in this new futures market are highly informative and underlying stock price volatility does not increase.

Most importantly, the above results are not isolated to the U.S. and Spain. For example, additional results reported in recent research studies such as Bhaumik and Bose (2009), Drimbetas, Sariannidis, and Porfiris (2007), and Ozun and Erbaykal (2009), among others, show that derivatives trading can be beneficial to cash markets in many non-U.S. markets such as India, Greece, and Turkey. Thus, these additional results not only replicate Hasbrouck's earlier U.S. findings but also provide empirical evidence on a global scale in support of the positive theories of derivatives markets noted in the prior sub-section of this report.

In sum, both finance theory and empirical tests of real-world derivatives markets demonstrate that the benefits of introducing a derivatives security such as the DBOR futures contract can have a positive impact on an economy by fostering greater information disclosure, lower volatility, and greater liquidity. All of these factors, in turn, can benefit society in general by allowing people to make more efficient financial and economic decisions.

V. Conclusion

This report has shown how the introduction of a contract such as the proposed DBOR futures instrument and the associated Cantor Exchange might affect the market for first-run movies. Using the classic, fundamental criteria that describe what effective futures contracts and financial markets should possess, I find that the DBOR contract and Cantor Exchange meet these criteria and thus represent a valid vehicle to conduct futures trading in the area of first-run movies. In addition, the role of speculators within a futures market is clarified using the CFTC's own description of these market participants. Contrary to the belief of some, speculators are not "gamblers" and thus these investors provide a useful economic role in ensuring liquidity and greater price transparency in a futures market.

This report also demonstrated how the introduction of a DBOR futures market can benefit not only the participants in such a market but also help other players in the movie industry such as consumers and the movie studios. The main benefits of introducing a DBOR futures market are:

(1) Better risk management for investors and other participants in the movie business,

(2) Increased new investment in the movie industry from current film investors,

(3) Additional investment from new investors that are now attracted to the film industry, and

(4) Greater transparency which yields useful price signals for the entire economy.

Two potential costs of such a market related to the possibility of market manipulation and/or insider trading are also examined. However, the financial incentives of the Cantor Exchange and the clear mandate of the CFTC to ensure that futures markets are fair to all participants indicate that both of these organizations have the proper motivation to actively employ the relevant surveillance and enforcement systems in order to mitigate the possibility of market manipulation and/or insider trading.

This report also reviewed the academic literature on this subject and I find that there is both strong financial theory and robust empirical evidence that support the notion that the benefits of introducing a futures market can outweigh the potential costs noted above. Empirical evidence over the past 2 decades not only in the U.S. but also more recent evidence from several countries around the world confirm the positive effects of introducing a futures market in terms of increasing price transparency, providing better risk management, reducing price volatility, and increasing the liquidity of financial markets.

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APPENDIX 1. EXCERPTS FROM SELECTED BUSINESS MEDIA ARTICLES

Excerpt from *Christian Science Monitor* article on 3/29/10 (Gloria Goodale and Dan B. Wood, "Trading 'movie futures' like pork bellies? MPAA fights the idea.")

Speculation isn't inherently bad

While the industry registers its protests, media and financial observers suggest that the issue is more complicated.

"The MPAA's concerns are a bit overblown—these claims against 'evil' speculators [are] age-old and ring a bit hollow because [they] ignore potentially very useful price signals," says Michael S. Pagano, professor of finance at the Villanova University School of Business in Pennsylvania.

"Speculators are not, by definition, bad for society," he says. "In fact, they can be quite good by providing liquidity and price signals that would not exist if these players were not present in the market."

Excerpt from *Christian Science Monitor* article on 4/9/10 (Dan B. Wood, "Big screen battle: Hollywood vs. box office speculators")

Legalized gambling?

The Chicago-based firm, Veriana, carries on its website this rebuttal, written by the Futures Industry Association (FIA):

> "The MPAA has asserted that futures trading is a form of 'legalized gambling' that has no commercial interest or value to the public. Nothing could be further than the truth. Futures markets have proven to be vitally important mechanisms for risk management, as evidenced by the phenomenal growth in the use of futures contracts by a wide range of commercial and industrial enterprises, both here and abroad."

FIA also counters MPAA claims that these new contracts could lead to "rampant speculation and financial irresponsibility. . . . It is clear that the MPAA is not familiar with the futures markets or the regulatory framework within which they operate."

Industry observers similarly line up on both sides of the issue. "I agree wholeheartedly with the MPAA and the movie industry who hold that this is pretty much a thin veil for basic gambling," says Chris Lanier, president of Motion Picture Intelligencer, a box office prediction firm. "If you want to lose all your money that badly, why not just go to Las Vegas?" And Douglas Gomery, a retired professor of the economics of cinema at Maryland University, has called the idea "gambling, pure and simple."

But Michael S. Pagano, professor of finance at the Villanova University School of Business, says there can be some legitimate reasons to have such an exchange.

New investors, more capital

"In particular, the trading of these contracts gives useful information to all market participants about the demand, profitability, and growth potential of various types of movies, including the film studios," Pagano says. "The exchanges can aid in the movie industry because film investors will now have a way to hedge their investments which, in the end, can attract new investors and generate more capital from existing investors."

He surmises other reasons for the vehement industry resistance.

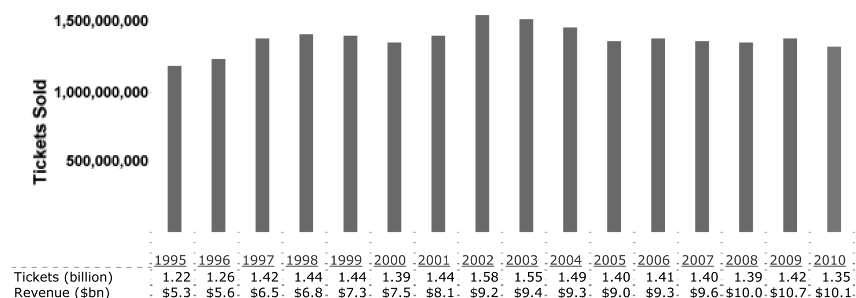
"It could be that the film studios are concerned that they will lose their monopoly position on information about various movies because the futures exchange will publish information which all market participants can then observe and analyze," says Pagano. "This is the type of information that is currently held privately by the film studios and thus they could be fearful of losing their informational edge to non-Hollywood players."

As debate continues to heat up prior to the CFTC's decision, Pagano says one concern of the film studios that is correct pertains to market manipulation.

"It is crucial that the exchange operator . . . create a set of trading rules and monitoring systems to ensure the market is a level playing field for all participants," he says. "Because if it is perceived to be a rigged market, then retail investors and possibly other market participants can be taken advantage of and this could also be disruptive to the film studios' operations."

APPENDIX 2. HISTORICAL DATA ON MOVIE TICKET SALES AND REVENUE (1995–2010)

Annual Ticket Sales



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Tickets (billion)	1.22	1.26	1.42	1.44	1.44	1.39	1.44	1.58	1.55	1.49	1.40	1.41	1.40	1.39	1.42	1.35
Revenue ($bn)	$5.3	$5.6	$6.5	$6.8	$7.3	$7.5	$8.1	$9.2	$9.4	$9.3	$9.0	$9.3	$9.6	$10.0	$10.7	$10.1

Note 1: Figures for 2010 are at an annualized rate.

Note 2: in order to provide a fair comparison between movies released in different years, all rankings are based on ticket sales, which are calculated using average ticket prices announced by the MPAA in their annual state of the industry report.

Data source is the movie industry data website: *www.the-numbers.com/market*

SUBMITTED LETTER BY CHARLES R. PLOTT, PROFESSOR OF ECONOMICS AND THE EDWARD S. HARKNESS PROFESSOR OF ECONOMICS AND POLITICAL SCIENCE, DIVISION OF THE HUMANITIES AND SOCIAL SCIENCES, CALIFORNIA INSTITUTE OF TECHNOLOGY

April 29, 2010

Hon. COLLIN C. PETERSON,
Chairman;
Hon. FRANK D. LUCAS,
Ranking Minority Member,
Committee on Agriculture,
House of Representatives,
Washington, D.C.

Re: April 22, 2010 Committee Hearing on Application of Cantor Futures Exchange, L.P.

Dear Chairman Peterson and Ranking Member Lucas:

I am a Professor of Economics at the California Institute of Technology. I have published extensively (over one hundred and fifty scientific papers) in the areas of market organization, risk, finance and information. I am a member of the National Academy of Science, American Academy of Science, and I am the recipient of numerous awards.

The Commodity Exchange Act recognizes that futures contracts serve the national public interest because the contracts are used for hedging and price discovery. From their earliest days, futures contracts have been used by farmers to help finance their purchase of seed and to facilitate their sale of crops. Futures contracts allowed farmers to lock-in all or a portion of their grain price to assure their bank that they can repay their loans and lock-in a profit regardless of the price of grain at the time of its sale. Over the decades, use of futures contracts have provided similar benefits for other physical commodity players, banks and others exposed to interest rate and currency fluctuations, investors concerned about stock prices and others interested in hedging exposures.

The benefit of any futures market is derived from risk sharing and the associated pricing of risk. The basic principle applies to films for the same reasons that it applies to any other futures market. Just as producers of grains base hedging on the resulting size of a crop, the investors and producers of films can base hedging off the size of the box office of a film. Through a focus on this key event the market is designed to accommodate the uncertainty that accompanies production efforts. It allows the sharing of risk and rewards and removes the full burden of risk from

the producer while facilitating the removal of risk from commerce and contracts related to the production of films. The key to the success is the identification of the risky event, which allows the building of risk sharing contracts conditional on the event. In the case of the movie industry, there seems to be little doubt that a major source of risk is the box office earnings of a film.

To date, the benefits of hedging and price discovery have not been available to the entertainment industry. The Cantor Futures Exchange's offering of Domestic Box Office Receipt futures will allow studios and others exposed to movie performance risk to hedge a portion of that risk. Just as agricultural futures have helped farmers, DBOR futures will allow studios to obtain financing on favorable terms and develop new sources of capital. DBOR futures also will allow professional and retail customers to take a position on the success of individual movies thereby providing an important source of price discovery and liquidity for the movie industry.

Consistent with the fundamental purposes of any futures market, the Cantor Futures Exchange, by facilitating hedging and risk shifting, will provide a new means of connecting the suppliers of capital and the demanders of capital. This provides studios and financial investors in film with more funding and less risky opportunities for producing films. The economic function of the Cantor Futures Exchange is to channel capital into productive use from the hands of those who own capital into the hands of those that can productively use the capital. The Exchange does this by crafting instruments that allow hedging and the removal of individual risk. In addition, the Exchange will create instruments that aggregate information, making success or failure more predictable and in doing so will remove risk from the system and encourage greater investments. The DBOR contract is an important part of this effort.

Existing Barriers to Efficient Capital Flows

Today there is an obvious absence of a broad-based capital flow into the entertainment field. Many barriers exist. Currently, the only ways through which an investor can participate in the profit potential of individual films are (i) invest in a studio, which is actually a portfolio of films and other assets or (ii) participate as a partner/owner of a film with a studio. Alternative (i) does not permit the investor to specialize investment strategies to the particular films about which the investor might have some information or opinions. The investor's funds are applied to the priorities as seen by the studio. Alternative (ii) involves many risks. First, the risks are large and concentrated. Each film is an expensive undertaking about which the uncertainty is great. The film requires a large investment while at the same time there is poor information about likely success. Such risks loom large for the studios, much less the individual investor, who faces even greater uncertainty due to an inherent moral hazard. Ownership is in terms of shares of profits but the individual investor might have little control over or information about costs. Contract monitoring and enforcement are expensive and requires specialized expertise, skills, and experiences.

Improving Economic Efficiency: The Cantor Futures Exchange

Through a combination of new organizational relationships, specially crafted financial instruments and the establishment of an efficient system for exchange, the Cantor Futures Exchange serves to remove the major barriers to economical capital flows to the entertainment industry.

One barrier has been the absence of easily verifiable measures on which returns to capital can be based. Profits would be the natural measure except costs are difficult to measure, verify and attribute to interrelated business activities. The Cantor Futures Exchange solves that problem through a focus on domestic box office receipts.

- Box office receipts are a verifiable, quantitative measure of success.

By developing a measure of success of a movie and by crafting special financial instruments based on that measure, the success can be decomposed into smaller measures and distributed among more participants. Instruments that are based on a proportion of box office receipts can be sold in smaller lots and thus provide access to broader participation. As a result, the risk can become more diffused and spread across a larger number of entities.

- The Cantor Futures Exchange DBOR futures contracts facilitate both diffusion and a broader sharing of risk, thereby increasing the economic attractiveness of movie investments.

Bringing together the suppliers of capital and demanders of capital is no simple task. Economic issues exist between the studios and the investing public and eco-

nomic issues also exist among members of the investing public. After the capital has been transferred to the studios, following the initial investments, various members of the investing public using DBOR futures contracts will now have an opportunity to lay off some of that risk in an efficient marketplace.

- The Cantor Futures Exchange will increase market efficiency by supporting the portfolio adjustment needs of asset holders such as:

  (i) pricing and price discovery;

  (ii) clearance and settlement—trades made by trusted parties (institutional and individual customers); and

  (iii) new physical environments to conveniently bring investors and speculators together.

A major function of markets is the reduction of risk through the aggregation of information and beliefs. Markets are known to have the capacity to aggregate and merge the different opinions and information that is dispersed across the experiences of many people. Prices in a properly functioning market can more efficiently reach balanced levels through the improved flow of information. The futures market will provide indices that help investors become aware of events that are known to others and thus help investors avoid the unexpected. This improved flow of information will be of use to both the studios and the investing public.

- The Cantor Futures Exchange DBOR futures market will improve market efficiency by improving the information and thereby reducing uncertainty.

The introduction of DBOR futures serves several functions. First, such contracts allow appropriate hedging by the individual investors, thereby allowing them to achieve the efficiency advantage of a portfolio. Second, DBOR futures carry information about both future events and the likely movement of spot prices. Both are central to uncertainty reduction.

Market risks are not the only risks that investors face. Today's investors have become very sensitive to corporate misbehavior. The perceived risk dampens appetites for new investments and inhibits the flow of capital to the producers of assets.

- The Cantor Futures Exchange DBOR futures contracts inherently protect the participating public's interests.

  (i) Information about box office receipts is reported independently of those who have raised the revenue (the studios). Thus, the system does not depend upon the good faith of the studios who would otherwise have a potential conflict of interest;

  (ii) Contracts are structured such that potential conflicts of interest between the studio and participants are removed; and

  (iii) The exchange prohibits participation by certain insiders holding material non-public information.

Cantor has a clear interest in supporting a successful market. Misbehavior by studios will be detrimental to Cantor's interest. To protect that interest, Cantor has employed the skills and procedures developed through decades of successful operations in asset markets.

The proposed market is structured to be efficient. Cantor has the capacity to support hundreds of different contracts trading at the top velocities experienced by markets throughout the world. Price movements are efficient and natural. The mechanism proposed for the initial sale of futures, the one price auction, is known to be the most efficient of the call auction forms.

- The market architectures of the Cantor Futures Exchanges are the most efficient known. The Exchange will operate in a manner that is fair to all participants and efficient.

In summary, the Cantor Futures Exchange's offering of DBOR futures is based on the traditional goals of any futures exchange: hedging and price basing. The Exchange will allow a broad range of investors and others with interests in movie performance to manage their risk. By permitting these hedging opportunities, DBOR futures will facilitate the efficient flow of capital from investors interested in a movie's success to studios interested in raising low cost capital and reducing their exposure to a movie's performance. At the same time, speculators and others with an opinion on a film's box office receipts will be able to purchase or sell DBOR futures, allowing the market to be an efficient location for price discovery. In these impor-

tant respects, DBOR futures will serve a valuable economic purpose for the entertainment industry.

Sincerely,

CHARLES R. PLOTT, *The Edward S. Harkness Professor of Economics and Political Science.*

SUBMITTED LETTER BY ANN RUTLEDGE, M.B.A., ADJUNCT ASSOCIATE PROFESSOR, DEPARTMENT OF FINANCE, HONG KONG UNIVERSITY OF SCIENCE AND TECHNOLOGY

New York, April 30, 2010

Hon. COLLIN C. PETERSON, *Chairman,* Committee on Agriculture, House of Representatives, Washington, D.C.;	Hon. FRANK. D. LUCAS, *Ranking Minority Member,* Committee on Agriculture, House of Representatives Washington, D.C.

Re: April 22, 2010 Committee Hearing on the Cantor Futures Exchange, L.P.

Dear Chairman Peterson and Ranking Member Lucas:

My name is Ann Rutledge, and this is an unsolicited letter of support for the Cantor Fitzgerald Cantor Futures Exchange. I am an adjunct assistant professor in the Hong Kong University of Science and Technology department of finance.

With Sylvain Raynes, I co-authored two books on the structured finance market, ***The Analysis of Structured Securities: Precise Risk Measurement and Capital Allocation*** (2003) and ***Elements of Structured Finance*** (2010), both published by Oxford University Press. I am also the co-founder of R&R Consulting, an early critic of structured finance ratings and highly regarded credit risk measurement service provider.

In the last 15 years, my professional focused has been structured finance and asset securitization, but in the early 1990s I headed J.P. Morgan's Asian prime brokerage business and consulted to the Hong Kong Futures Exchange (now part of HKEX, on clearinghouse reform, new listings, including the successful Hang Seng Option, plus some failed contracts) and managing external relations with Chinese reformers studying the role of exchanges in improving the circulation of information and goods through the Chinese economy.

Most of the arguments I have read for and against DBOR are standard arguments about the risks and benefits of futures exchanges or new contract markets, generally. They do not specifically address the risks and benefits of film futures. Certainly such arguments are still relevant to the case of DBOR because all futures markets have certain attributes in common, namely—

- They allow the commercial producer or processor to manage the risk of its business flows by hedging (taking the opposite side of their natural position);
- They have the backing of a clearinghouse to manage price volatility and counterparty risk;
- They have a central administration to design the contract market and make the rules and regulations for membership, trading, reporting, disciplinary action and other key functions, which they enforce.

It may be difficult for the layman to understand how these points relate to film production, which, at first blush, seems to have nothing in common with agriculture or finance. Film studios, like any other commercial institution, must sell what they produce at a profit. Although they have managed to convince the public that film economics cannot be rationalized, studios nevertheless manage to run profitable businesses.

In the lingo of futures, a film studio that makes films is a natural "long." The existence of a futures market in films gives studios an ability to sell contracts on unmade films at an internal target to hedge their price risk. A distributor of these films, or rights to them, is a natural "short." Distributors can lock into profits by taking the other side of the trade, *i.e.*, selling contracts on the unmade films. If the long and short interest is in balance, liquid interest will develop around the futures contract, which will encourage further buying and selling by smaller, speculative institutions that give the contract market liquidity. This enables the commercials to rebalance their positions flexibly as they require. The availability of a symmetrical

risk management tool is expected to have a salutary effect on the film industry generally as it shifts the focus of film studios and distributors from extracting surpluses from each other to monetizing the films they make and distributing them at fair value.

From the foregoing explanation, it should be easy to understand why commercial producers are almost always the slowest to accept a futures market. They have a powerful information edge over the rest of the market, and they believe they lose far more by opening up their price advantage to competitive bidding than they gain from access to a risk transfer mechanism. This is how banks originally viewed financial futures, and film studios are no different. It is as natural for them to resist the establishment of film futures in the 2000s as it was for banks in the 1970s to reject financial futures, even though they later adopted financial futures wholesale. The adverse response of the studios is not simply a maneuver to hide the industry's accounting games, as Dr. Chance suggests in his testimony, though that may be part of the motivation as well.

The second and third bullets above are further reasons to consider the timeliness and advisability of creating a film futures market. As Dr. Chance mentions, the studios have dabbled in the nascent OTC securitization market for film since 1996, when the credit rating agencies began rating royalty receivable backed transactions. (Sylvain Raynes developed the method for Moody's.) In this decade, some studios used the film slate deal format to lay off the risk of failed films on to unsuspecting investors at a price that did not reflect intrinsic value.

As we are learning from the Subprime Crisis, the OTC market format lacks key controls of a formal exchange. Credit rating agencies fulfill some of the roles of the administrator in the OTC market, but they do not ensure continuous price (rating) feeds or clearinghouse protection from the impact of counterparty defaults. Given that the studios are already using financial engineering to redistribute the risks of the films they make, bringing this activity into an organized exchange offers investors better protection and may to some extent curb the production of bad movies that get made because they can be fraudulently off-loaded.

Many people doubt that the studios could actually engage in adverse selection because they do not believe film revenue cannot be estimated reliably. R&R disagrees. We have devoted considerable internal resources to developing a predictive algorithm for the revenues of independent film in the $7–$20 MM category at script stage (*i.e.,* before the first box office weekend), and the revenue estimates from it achieve an R^2 of over 90% when compared to a database of over 500 films. While these results do not provide an open-and-shut case for revenue certainty, they do provide evidence that revenue benchmarking is possible in the indie category, and that trading in an exchange venue could be quite robust because the variance could be small enough to attract a tradable bid-asked spread.

Finally, Dr. Chance is right to observe that the DBOR market may fail on its own, even if Congress approves it. Then, no one will be the worse off, because very little trade will have taken place and the risk exposures will be *de minimus.* On the other hand, if DBOR is a good idea but the industry needs time to come around to it, we may be worse off if Congress votes it down. It is not common knowledge that the Chicago Mercantile Exchange's wildly successful Eurodollar market, built in the 1970s, stumbled for a decade until banking system and capital reforms in the 1980s gave U.S. banks a motivation to join. Yet the Eurodollar market laid the foundation for swaps and other engineered products that put the U.S. financial system in the driver's seat of change and progress. It is easy to overstate the unintended negative consequences of change, but the unintended negative consequences of delaying inevitable change may be much more costly.

Sincerely,

ANN RUTLEDGE.

SUBMITTED QUESTIONS

Questions Submitted by Hon. Leonard L. Boswell, a Representative in Congress from Iowa

Dan M. Berkovitz, General Counsel, Commodity Futures Trading Commission

Question 1. You acknowledge that the Commission has recognized that media contracts may require special review to ensure that the contracts are consistent. Why is that?

Answer. Staff reviewed the contracts to determine whether the contracts satisfied (are consistent with) core principles applicable to contracts—primarily Core Principle 3 (Contracts Not Readily Subject To Manipulation) and Core Principle 5 (Position Limitations Or Accountability). Staff gave heightened review to the motion picture revenue contracts under these core principles due to the unique and novel nature of the contracts. Staff determined that the terms and conditions of the motion picture revenue contracts from both Exchanges appeared to meet the standards for cash-settled contracts.

Question 2. What is the price discovery function or aspect to these markets?

Answer. The futures contract provides a market-determined estimate of the motion picture revenues over the defined revenue periods. Assuming that the proposed contracts develop a reasonable amount of trading volume, the futures contracts could provide a price discovery mechanism where there currently is no such mechanism.

Question 3. Please provide your views on proposed Senate language that would ban movie futures contracts by amending the Commodity Exchange Act to read that no exchange be allowed to offer contracts based on "motion picture box office receipts (or any index, measure, value, or data related to such receipts)."

Answer. Congress excluded motion picture box office receipts related contracts from the definition of commodity in the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted on July 21, 2010. The Commission, of course, will enforce that law.

Response from Robert S. Swagger, Chairman and CEO, Media Derivatives, Inc.

Question 1. You cite an existing opaque over-the-counter market for trading of motion picture products. Could you elaborate on this? Who engages in it? How large is it?

Answer. The Trend Exchange, Inc., also known as Media Derivatives, Inc. ("MDEX"), appreciates the opportunity to respond to the two questions raised by Chairman Boswell.

As we testified at the hearing, MDEX is not seeking to establish a market for the trading of motion picture products in an opaque over-the-counter ("OTC") market. Based upon conversations with entertainment industry participants, we understand that a fragmented private financing market already exists. In this market, participants attempt to manage risk using various techniques, including the equivalent of collateralized loan obligations ("CLO") and OTC options. Given the opacity of the OTC market, we are not aware of the size of this market.

We understand that approximately $20 billion of production capital is expended annually on the creation of motion pictures in the United States. Approximately $15 billion of this amount is raised from studios using their balance sheets, often through partnerships with large private equity investors or syndicates of equity investors. The remainder is raised through a combination of single picture financing and so-called "slate financing" that does not involve major studios, but includes private investors and financial institutions. A significant portion of this financing is raised outside of the United States and is inclusive of tax benefit driven structures.

The process of raising slate financing is similar to that of a CLO, which some characterize as a form of OTC derivative. CLOs are originated by investment banks and investors in tiered investment structures comprising of senior debt, mezzanine debt and equity debt. There is a very limited secondary market for these interests that are traded from time to time between this small group of participants. All of this financing—which is significant by any measure—occurs solely outside of the public view and subject to no Congressional or agency oversight. MDEX simply seeks to bring the demonstrable benefits of futures contracts—such as pricing transparency, liquidity and centralized clearing in a regulated environment—to the highly uncertain and variable outcome of movie box office revenues.

Moreover, as of this writing, a form of unregulated offshore trading in movie box office futures occurs in foreign markets. Most notably, on Intrade, a market based in Ireland, you can place trades on the opening weekend box office results of major U.S. motion pictures. The Intrade market is open to the public, including U.S. citizens which trade in the market, is unregulated and relies upon leverage. We believe that an unintended consequence of the box office ban will be to push U.S. movie production and financing market participants to offshore potentially retail, leveraged markets that are subject to no oversight by the CFTC or Congress.

Rather than push market participants offshore, MDEX seeks to list and clear contracts in a fully regulated and transparent fashion, subject to comprehensive CFTC oversight and sound risk management principles.

Question 2. Please provide your views on proposed Senate language that would ban movie futures contracts by amending the Commodity Exchange Act to read that no exchange be allowed to offer contracts based on "motion picture box office receipts (or any index, measure, value, or data related to such receipts)."

Answer. We strongly oppose the language in the Senate bill that would ban futures contracts based upon movie box office receipts (the "box office ban"). The box office ban is both unnecessary and unprecedented since the creation of the Commodity Futures Trading Commission ("CFTC") in 1974. On a sole occasion in 1958—prior to the creation of the CFTC—Congress banned the listing of futures contracts on onions.

Rather, we believe that the CFTC is the proper forum for resolving the review and analysis of the product, and Congress should reject any attempt to subvert the regulatory process. The CFTC has the expertise and resources necessary to conduct market surveillance with respect to the commodity upon which MDEX seeks to list futures contracts, and the CFTC has demonstrated its expertise during periods of extreme market stress, such as during 2007–2009.

As you may know, the movie box office ban in the Lincoln-Dodd compromise amendment to S. 3217 was added to the bill with no notice, knowledge or discussion with our exchange or many others in the futures community. While MDEX has sought strictly to adhere to the requirements of the Commodity Exchange Act ("CEA"), our transparent and open efforts have unfortunately been met with an attempted subversion of a well-established, Congressional mandated regulatory process.

We understand that the box office ban is based partly upon the misplaced notion that such futures contracts may damage the entertainment industry and amount to "illegal gambling." This notion is without demonstrable support. As we testified, over the past several decades, numerous industries have made the same claim with respect to futures contracts only to find that such products ultimately provide a critical risk management tool, which include the U.S. Government and the listing of Treasury futures; the housing industry and the listing of housing futures; the insurance industry and the listing of weather futures; the aluminum industry and the listing of aluminum futures; and the agricultural industry and the listing of various agricultural futures.

In fact, derivatives are widely used today in virtually all industries to manage risk. According to Professor René Stulz, 29 of the 30 companies that comprise the Dow Jones Industrial Average—*i.e.,* America's "blue chip" companies—use derivatives.[1] Further, in 2009, ISDA conducted a survey on the use of derivatives by Fortune Global 500 companies and found that 94 percent of these companies use derivatives to manage business and macroeconomic risks.[2] We believe that the notion that regulated futures contract tarnishes an industry and is tantamount to "legalized gambling" is patently outdated and uninformed.

Further, we oppose the box office ban because we believe that the development of movie box office futures and related risk management products is consistent with a major thrust of Congressional legislative history which seeks to promote, among other things, innovation with respect to risk management tools such as futures contracts. To the extent that Congress permits the movie box office ban to remain in the Senate bill, it would severely discourage the development and investment in innovative risk management tools while telegraphing that an industry may on a piecemeal basis attempt to subvert the CFTC's regulatory process.

Finally, we believe that a box office ban would continue to push U.S. investors to foreign leveraged markets that are not subject to any oversight by the CFTC or Congress. As we testified, unregulated foreign markets trade products based upon movie box office revenues and related measures. This market is open to the public, unregulated and employs leverage.

Rather than push market participants offshore, MDEX seeks to list and clear contracts in a fully regulated and transparent fashion, subject to comprehensive CFTC oversight and sound risk management principles.

We thank you for the opportunity to respond to these questions.

Response from A. Robert Pisano, President and Interim CEO, Motion Picture Association of America, Inc.

Question 1. You have indicated that your members would not use these exchanges to hedge and that one of the characteristics of legitimate commodity futures contracts is that they are designed to serve the interests of the industries that use the underlying commodities by providing a means for price discovery and hedging. If in-

[1] René M. Stulz, *In Defense of Derivatives,* WALL STREET JOURNAL, April 6, 2009, at A15.

[2] ISDA Research Notes, No. 2 (2009), at 1.

vestors in your studios or other entities in the film industry were to indicate that they would use the product to hedge their financial risk, would that change the association's position even if your studios themselves would not participate?

Answer. We do not believe that the proposed contracts can be used as hedging vehicles. If someone tries to do so, we believe that they will not find the contracts to be useful hedges. In any event, the MPAA would remain opposed to the contracts for the reasons stated in my testimony.

Question 2. How do you respond to concerns that if these exchanges are not approved and regulated in the United States, they will simply be used offshore and without the regulatory mechanisms we currently have in place?

Answer. The Commodity Exchange Act has permitted trading in over-the-counter swaps among sophisticated "eligible contract participants" for the past ten years. No over-the-counter swap market in anything like the MDEX or Cantor contracts has developed. There is no reason to believe one would now. Underscoring our views is the fact that these contracts are gaming contracts that are prohibited by the Wire Act from being bought and sold over-the-counter. That is why the Hollywood Stock Exchange allows only make believe betting on such contracts now—no money changes hands. We are not aware of any proposals before foreign futures regulators to trade futures in motion picture box office receipts. We would oppose any such proposals as vigorously as we oppose the current proposals in the U.S. We believe that prohibiting such contracts in the U.S. will send a clear and strong message around the world that such contracts should not be permitted.

Question 3. Please provide your views on proposed Senate language that would ban movie futures contracts by amending the Commodity Exchange Act to read that no exchange be allowed to offer contracts based on "motion picture box office receipts (or any index, measure, value, or data related to such receipts)."

Answer. We fully support that language and the ban. Motion picture box office receipts are not a commodity. There is no cash market for them; they are not bought and sold. Nor do they provide a valuation of any cash commodity. Industry contracts that are tied to box office receipts are governed by actual receipts, not Rentrak numbers or studio estimates. The contracts do not provide a price discovery function and they are not useful for hedging. Accordingly, it is not appropriate that they be within the definition of commodity.

Response from Scott Harbinson, International Representative, International Alliance of Theatrical and Stage Employees; on behalf of Directors Guild of America

Question 1. You have pointed out the effect that negative box office predictions could have on residuals, which have a direct financial impact on your members. However, Facebook and Twitter have already revolutionized the way people communicate about movies, notably by spreading bad reviews more quickly further damaging a movie that might have made some minimum amount on opening weekend or opening night. Have you seen an impact from this information exchange on box office revenues, and therefore, your members' residuals?

Answer. Social media is simply a broader extension of film reviews by newspapers, blogs and entertainment shows. Twitter and Facebook are relatively new outlets and we are not in a position to measure their ultimate impact, if any, on residuals payments to our members, especially given the lag time between the theatrical release of a movie and when residuals are generated from downstream revenues. Additionally, demonstrating such cause and effect specifically attributed to such social media is difficult given all of the other variables involved in determining box office receipts.

Comparing the impact of new social media participation to the potential impact that movie futures contracts could have on the film industry is not an apt comparison. Participation in social media today (*i.e.,* "tweeting" opinions about a particular film) is not motivated by an underlying financial interest to disseminate negative information to make money by "shorting" that particular movie's future contract.

We are aware of a recent study conducted by two researchers at HP Labs that analyzed millions of "tweets" on movies over a three month period. That study included two preliminary findings:

1. The volume of tweets (no matter if positive or negative) correlated to the box office success for the opening weekend, and

2. The ratio of positive to negative tweets, combined with the volume of tweets, correlated to box office success in the following weekend (*i.e.,* if more positive than negative the better the results).

Thus, we would be most concerned about potential manipulation of social media outlets and the adverse impact that could have on box office receipts if movie futures contracts are approved.

Question 2. You have indicated that if the CFTC does not have the authority to reject these applications, then Congress should act. Would you support acting even if that means that these exchanges still occur, but on foreign, unregulated markets?

Answer. Yes, we would support Congress acting to prevent such commodities exchanges from being created. Currently such trading with "play money" (Hollywood Stock Exchange) or on foreign owned websites (Intrade, which is based in Ireland) does not have the same potential to harm the industry on the scale a U.S. Government-sanctioned trading platform would create. Because of the scope, number of films released, financial investments and other defining features of the American film industry, these newly proposed exchanges could have far greater detrimental impact on a film's success. While there other nations allowing on-line gambling, that does not seem a justifiable reason for it to be approved in the United States.

Question 3. Please provide your views on proposed Senate language that would ban movie futures contracts by amending the Commodity Exchange Act to read that no exchange be allowed to offer contracts based on "motion picture box office receipts (or any index, measure, value, or data related to such receipts)."

Answer. We believe such a blanket exemption is necessary. We also believe it is narrowly crafted to make clear the Congressional intent that while derivatives futures trading in box office receipts or related data would be prohibited, the language would not hinder the creation of other types of legitimate derivatives in the future.

Response from Schuyler M. Moore, Adjunct Professor, UCLA School of Law; Adjunct Professor, UCLA Anderson School of Management; Partner, Stroock & Stroock & Lavan LLP

Question 1. You have indicated that the exchanges will enhance transparency. However, with one exchange beginning sales 6 months from a movie's release and the other proposing to begin sales just 4 weeks from a movie's release, that doesn't seem like a lot of time to shed light on the market. Is that sufficient to add more transparency to this industry or would longer timeframes have added value?

Answer. The value of transparency is having the value of a film investment be directly based on the film's box office results, since that alone eliminates all the lunacy of normal Hollywood accounting. Thus, it really doesn't matter how much earlier than release the exchange starts; what matters (for transparency) is that the investors will get paid based on box office results.

Question 2. Please provide your views on proposed Senate language that would ban movie futures contracts by amending the Commodity Exchange Act to read that no exchange be allowed to offer contracts based on "motion picture box office receipts (or any index, measure, value, or data related to such receipts)."

Answer. This language was added at the request of the MPAA for the reasons I mentioned at the hearing: (a) fear of anything new and (b) fear that the public won't go to a film that is tracking badly on the exchange. I think these fears are misguided (for the reasons I stated at the hearing), and I am hoping for the sake of the industry—including the studios—that this language gets deleted from the bill. The odd part of the MPAA knee-jerk objection is that the box office exchange concept will bring badly needed capital to the studios.

I sincerely thank Chairman Boswell for taking the time to study this issue.

SCHUYLER M. MOORE.

Response from Richard Jaycobs, President, Cantor Futures Exchange, L.P.

Question 1. You mention that settlement of the contract is based on the box office receipts as reported by the distributor of the film and captured by Rentrak. Aren't there incentives for the distributors of a film to report inaccurate figures or to inflate figures?

Answer. It is generally true that studios have an incentive to report inaccurate or inflated box office figures. However, Cantor Exchange will compare the studio released numbers to Rentrak's electronically tabulated numbers on a weekly basis in order to identify any situation where the studio numbers appear to be inaccurate. In the event the Exchange detects a material difference between a distributor's reported number and the electronic tabulation, the exchange Compliance Department will conduct an investigation together with the National Futures Association and, if necessary, the CFTC to determine if any manipulation had, in fact, occurred. In addition, if the studio released numbers were found to be inaccurate or inflated, Cantor would modify its contract specification to settle its DBOR contract to Rentrak's electronically captured number.

Question 2. In your testimony, you mention seeking input of a wide range of individuals and entities throughout the motion picture industry while you were structuring your business model. What kind of feedback did you receive? What were the most common concerns voiced by the industry insiders? Did you receive any indication before the MPAA letter that those in the film industry were opposed to the markets?

Answer. Cantor openly and widely discussed its box office contract over a period of almost 2 years to a broad range of motion picture industry participants. During this process, Cantor learned of potential concerns, but there was no indication before the MPAA letter that it would oppose the contract market or attempt to make it illegal through legislation.

There were three concerns identified by the industry during the process of developing the market: (1) would the market have sufficient size and depth to be useful as a hedging tool; (2) would studios be viewed negatively or suffer legal consequences if investors lost money to studios who chose to 'short movies'; and (3) would studios suffer legal consequences because of their unique position as distributors of film?

Our response to these concerns was generally (1) while there can be no assurance of liquidity in launching a new market, based on Cantor Fitzgerald's long record of enhancing market efficiency, the company would make every attempt to facilitate an effective hedging platform; (2) that the motion picture industry had a long history of benefiting from the sale of interests in film titles to outside investors; and (3) that the exchange rules would be crafted to provide sufficient safe harbors for industry participation.

Question 3. Please provide your views on proposed Senate language that would ban movie futures contracts by amending the Commodity Exchange Act to read that no exchange be allowed to offer contracts based on "motion picture box office receipts (or any index, measure, value, or data related to such receipts)."

Answer. Cantor opposes a legislative ban on futures contracts based on motion picture box office receipts for the following reasons:

—Under the current law, the CFTC has sufficient legal authority to determine whether a public market in box office contracts serves the public interest;

—The proposed ban would set a unique precedent of Congressional intervention in determining the appropriateness of a market before the regulatory process has been allowed to conclude;

—The proposed ban is a rush to judgment at the request of a certain group of market participants. Despite a two year process with the CFTC and over 200 filed documents, proponents of movie box office futures were not provided an opportunity to present support for their position with the Senate;

—The proposed ban will support the entrenched interests and competitive monopoly position of the major studios because smaller entities in the motion picture industry will continue to depend on major studios for financing and distribution.

Questions Submitted by Hon. Blaine Luetkemeyer, a Representative in Congress from Missouri

Question 1. Please explain the process for evaluating an application or request to create a new derivatives market (or series of contracts). Describe the questions and then the answers that Media Derivatives and Cantor Exchange provided that led the CFTC staff to recommend approval of the application. Include a timeline on the entire process as well (application received, length of q/a process, letter of approval, *etc.*).

Answer. An interdivisional team was assembled to review the MDEX and Cantor applications for compliance with 8 designation criteria and 18 core principles. To that end, each exchange submitted substantial documentation including, among other things, rulebooks, compliance manuals, governance documents and regulatory charts and also provided trading and system demonstrations at their respective headquarters. The staff evaluated all the information and made a recommendation to the Commission to approve the application for designation which was accepted by the Commission.

MDEX submitted draft documentation as early as October 2008 and formally submitted its application in September of 2009. MDEX was designated on April 16, 2010.

Cantor submitted draft documentation as early as June 2008 and formally submitted its application in November 2008. Cantor was designated on April 20, 2010.

Question 2. What are the most important factors that led the review team to make its decision? For example, was the CFTC focused on evaluating whether the

new contract(s) being proposed would have a legitimate business purpose (for say, risk management)? What other questions or answers were also viewed as central to the application?

Answer. The contract approval determination primarily addresses whether the proposed contract would be readily susceptible to manipulation. Staff was satisfied that both MDEX and Cantor had developed product rules, systems and safeguards in order to reasonably assure that the contracts were *not* readily susceptible to manipulation.

Question 3. In 2008, the CFTC issued a request for comments about whether and how it should regulate prediction markets. Please summarize the questions asked, the comments received, and any new processes or plans that resulted within the CFTC for how to regulate prediction markets and/or process these sorts of applications.

Answer. The Commission previously requested comment on the appropriate regulatory treatment of financial agreements offered by markets commonly referred to as event, prediction, or information markets (event contracts) in 2008. The Dodd-Frank Wall Street Reform and Consumer Protection Act provides the Commission with authority to prohibit listing of certain agreements, contracts, or transactions based on commodities contrary to the public interest (*e.g.,* contracts on terrorism, assassination, war or gaming). The Commission will consider the new legislation prior to enacting regulations regarding event contracts.

Question 4. In reviewing the applications by Media Derivatives and Cantor Exchange, how did or does the CFTC view these proposed businesses as distinct from the Iowa Electronic Market (and the previous "no action" letter that they received)? Is the difference more than just who has access to trade these contracts or the dollar amount of the contracts?

Answer. The University of Iowa requested no-action relief for its Iowa Electronic Markets (IEM). The IEM is an electronic trading market organized as an academic research and experimental program conducted at the University. The Division of Trading and Markets of the Commission extended no-action relief (that included limits on participation and dollar amounts) for the operation of the Political Market and the Economic Indicator Market on February 5, 1992 and June 18, 1993. Had the IEM not requested and been extended no-action relief, they likely would have had to apply to the Commission for designation as a contract market (just as MDEX and Cantor did) if they proposed to offer these contracts to the retail public.

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