Prediction Markets and the Economic Purpose Test

Part I of III: The Financialization of Event Risk Series

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ABSTRACT

Prediction markets have reemerged as a legally and politically salient feature of U.S. financial markets. Once confined to academic experiments and offshore platforms, they are now operated by CFTC-regulated exchanges, crypto-native intermediaries, and major financial institutions. Contracts settling on election outcomes, macroeconomic events, and other discrete contingencies have generated both enthusiasm for their informational value and resistance from state regulators who view them as unlawful gambling. The resulting conflict has exposed a deeper problem: U.S. law lacks a coherent, functional boundary between federally regulated derivatives and state-regulated gambling. This Article argues that the solution lies in making explicit a distinction that has long structured American risk regulation — the difference between *risk transfer* and *risk creation*. It proposes a unified analytical framework drawn from derivatives law and gambling law scholarship, translates that framework into existing Supreme Court doctrine, and proposes a targeted legislative fix to CEA § 5c(c)(5)(C).

I. PREDICTION MARKETS AND THE DRIFT OF DERIVATIVES REGULATION

From their origins in nineteenth-century agricultural futures markets, U.S. derivatives have been regulated as instruments designed to serve underlying "cash" markets. Futures contracts enabled farmers, merchants, and industrial users to hedge price volatility and provided reference prices that facilitated commerce. Speculation that creates new risk was tolerated because it supplied liquidity and enabled risk transfer.

As derivatives markets evolved, the scope of permissible underliers expanded dramatically. Financial futures, index products, and cash-settled instruments detached derivatives from physical delivery while retaining their connection to economic risk. Throughout this evolution, however, Congress consistently articulated the same statutory purposes: hedging and price discovery. The Commodity Exchange Act has never treated derivatives as an end in themselves.

Recent years have tested this settlement. Advances in automation and platform design have enabled exchanges to list large numbers of binary "event contracts" that settle on the occurrence or non-occurrence of discrete events — elections, awards, social outcomes, and other contingencies. These products may aggregate beliefs, but they often lack any identifiable class of participants using them to hedge an existing exposure or manage commercial risk.

The CFTC's authorization of such contracts has significant legal consequences. Contracts listed on CFTC-regulated exchanges fall within the Commission's exclusive jurisdiction, preempting state law, including state gambling prohibitions. When contracts that function primarily as wagers are swept into federal derivatives regulation, the CEA begins to operate as a vehicle for displacing state police power without a clear statutory rationale.

II. RISK TRANSFER VERSUS RISK CREATION: A UNIFIED FRAMEWORK

A. The CEA's Embedded Limiting Principle

Derivatives law itself contains the tools necessary to address this drift. As Ilya Beylin has shown, the CEA's twin statutory purposes (hedging and price discovery) operate as a limiting principle on federal jurisdiction.[1] Derivatives are regulated because they serve economically productive functions in underlying markets. Where a contract fails to advance either purpose, the justification for federal preemption weakens.

Importantly, this framework does not require that a majority of market participants be commercial hedgers. Speculation has always been integral to derivatives markets. What matters is whether the instrument plausibly facilitates the transfer or pricing of economic risk that exists independently of the contract itself.

B. Gambling Law: Parallel Insight

Gambling law scholarship converges on the same boundary from the opposite direction. Traditional definitions of gambling (consideration, chance, and prize) are notoriously overinclusive when applied to modern financial instruments. Insurance, securities, and derivatives all involve chance and payout, yet are not treated as gambling.

A more functional definition focuses on risk creation. Transactions that transfer pre-existing risk (such as insurance contracts or hedging derivatives) are not gambling. Transactions in which all participants are speculators, and in which risk is created solely through the contract, are.[2] This distinction explains why wagers on sporting events or elections are regulated differently from financial risk-management tools, even when both involve uncertainty.

C. Prediction Markets Push the Boundary

Prediction markets expose the overlap between these regimes. Some contracts may plausibly contribute to economic decision-making or price formation relevant to underlying markets. Others merely allow participants to take positions on uncertain events with no connection to economic exposure. Treating all such contracts as derivatives stretches the CEA beyond its historical and statutory purposes. Treating all prediction markets as gambling ignores meaningful differences in economic function.

The relevant question is therefore not whether prediction markets are useful or accurate, but whether a given contract transfers or merely creates risk.

III. SUPREME COURT DOCTRINE

From the Supreme Court's perspective, disputes over prediction markets present a familiar set of issues: federal preemption, agency authority, and statutory purpose. Gambling regulation has long been a core aspect of state police power. When a federal statute displaces that authority, the Court has demanded a clear justification grounded in congressional intent.

Early futures jurisprudence provides a template. In a landmark Supreme Court decision, Justice Holmes tolerated speculative trading not because it was harmless, but because it served legitimate commercial purposes.[3] Speculation detached from those purposes shaded into wagering. Although articulated in a different era, this functional approach remains doctrinally available.

A modern Court need not decide whether prediction markets are socially beneficial. It need only ask whether Congress intended the CEA to confer exclusive federal jurisdiction over contracts that do not facilitate risk transfer or price discovery. A functional inquiry grounded in economic purpose would allow the Court to cabin agency authority without invalidating the statute or engaging in moral judgments about speculation.[4] Such an approach also aligns with the Court's recent skepticism toward agency self-expansion. Authorizing event contracts does not merely regulate a new product; it reallocates regulatory authority between federal and state governments. Where an agency interpretation has that effect, the Court has increasingly required clear congressional authorization.

IV. A TARGETED FIX TO CEA § 5c(c)(5)(C)

Judicial clarification, while necessary, is unlikely to be sufficient on its own. The instability surrounding prediction markets originates in a narrow statutory provision added by Dodd-Frank: § 5c(c)(5)(C), which authorizes the CFTC to prohibit contracts involving, among other things, "gaming." The statute does not define the term, and "gaming" has no settled meaning in federal law.[6]

This ambiguity has invited subject-matter-based reasoning (elections, sports, awards) rather than analysis grounded in economic function. The result is doctrinal confusion and politicization of derivatives regulation.

A modest amendment would restore coherence. Replacing "gaming" with "gambling" in CEA § 5c(c)(5)(C), together with a functional definition of "gambling" as the creation of risk through the bilateral or multilateral exchange of bets, would align the statute with both derivatives doctrine and gambling law.[5] Such a definition could incorporate familiar elements (consideration, chance, and prize) while embedding risk creation as the limiting principle.

This change would not prohibit prediction markets. It would clarify that markets designed to facilitate betting rather than risk transfer fall outside the core of federal derivatives regulation unless Congress affirmatively decides otherwise. Federal jurisdiction would remain available for speculative markets that plausibly serve hedging or price-discovery functions.

CONCLUSION

Prediction markets have forced U.S. law to confront a boundary it has long left implicit. For more than a century, derivatives regulation has tolerated speculation not as an end in itself, but as

an instrument for transferring and pricing economic risk. Gambling law, by contrast, has focused on the creation of risk through wagering. Modern prediction markets sit uneasily between these regimes, exposing the costs of doctrinal drift.

This Article has argued that the resulting conflict is neither novel nor intractable. The distinction between risk transfer and risk creation is already embedded in the history of futures jurisprudence, the statutory purposes of the Commodity Exchange Act, and contemporary gambling law scholarship. What has been missing is an explicit recognition of that distinction as a jurisdictional boundary.

The Supreme Court is well positioned to supply that clarification through existing doctrines of statutory purpose and federalism. A modest legislative refinement — replacing the undefined term "gaming" in § 5c(c)(5)(C) with a functional definition of "gambling" grounded in risk creation — would provide a durable complement to judicial doctrine. Together, these interventions would not prohibit prediction markets, but rather sort them according to economic function and regulatory competence.

Prediction markets will continue to evolve. Whether they do so within a coherent legal framework depends on whether courts and policymakers are willing to articulate the boundary that has always structured American risk regulation, even when it was left unstated. Making that boundary explicit is not a retreat from innovation; it is a precondition for its sustainable growth.[7]

NOTES AND AUTHORITIES

1. Ilya Beylin, *Event Contracts Are a Step Too Far for Derivatives Regulation*, 4 University of Chicago Business Law Review 77 (2025).

2. William Bunting, *A Better Legal Definition of Gambling: With Applications to Synthetic Financial Instruments and Cryptocurrency*, 86 Albany Law Review 257 (2023).

3. *Board of Trade v. Christie Grain & Stock Co.*, 198 U.S. 236 (1905).

4. Karl Lockhart, *Betting on Everything* (Feb. 1, 2025), available at https://ssrn.com/abstract=5317376.

5. Bunting, *supra* note 2, at 281 (proposing a model statutory definition of gambling that includes risk creation as a limiting principle, under which gambling means "[t]he creation of risk through the bilateral exchange of bets"; noting that conventional gambling law defines the three traditional categories of regulated gambling as lotteries, wagers, and gaming; and classifying lotteries and wagers by exogenous risk characteristics — where the outcome is determined by chance independent of the parties' efforts — and gaming by endogenous risk characteristics, where the outcome is a function of effort exerted by the contract parties themselves).

6. The term "gaming" in § 5c(c)(5)(C) was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 721, 124 Stat. 1376, 1669 (2010). At the time of Dodd-Frank's enactment, commercial sports betting was lawful in only a small number of jurisdictions, as the Professional and Amateur Sports Protection Act of 1992 (PASPA), Pub. L. No. 102-559, 106 Stat. 4227 (codified at 28 U.S.C. §§ 3701–3704 (2012)), prohibited most states from authorizing sports wagering. PASPA was not invalidated by the Supreme Court until 2018. *Murphy v. National Collegiate Athletic Ass'n*, 584 U.S. 453 (2018). Because sports betting was unlawful in virtually every state when § 5c(c)(5)(C) was drafted, the drafters plausibly understood that any event contract tied to a sporting outcome would have been separately prohibitable under the statute's existing hook for contracts "illegal under . . . State law" — making a distinct "gaming" prong directed at sports wagering redundant. On this reading, the intended scope of "gaming" is genuinely ambiguous, and its drafting history does not resolve whether the term was meant to reach wagers on exogenous sporting outcomes or something narrower.

7. This Article is Part I of a three-part series. Part II — David Kuhn, *The Financialization of Event Risk: From Risk Warehousing to Risk Intermediation* (Feb. 2026) — examines whether prediction markets will compete with or transform sportsbooks, and develops the risk-warehousing-to-risk-distribution thesis. Part III — David Kuhn, *Event Contracts and the Liquidity Threshold: Risk Transfer, Sportsbook Exposure, and the Derivatives Case for Event Markets* (Mar. 2026) — introduces the Liquidity-Constrained Event Risk Transfer Curve and develops a quantitative framework for assessing when event contracts can support economically meaningful risk transfer. Both papers are available at eventrisk.ai.

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