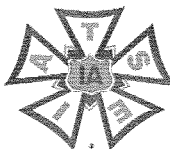




**Independent** ■  
Film & Television  
■ ■ ■ **Alliance**®



8 April 2010

David Stawick, Secretary  
Office of the Secretariat  
Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

**Re: Application of Media Derivatives, Inc. for Designation as a Contract Market**

Dear Mr. Stawick:

The Directors Guild of America, Inc. ("DGA"), the Independent Film & Television Alliance ("IFTA"), the International Alliance of Theatrical Stage Employees ("IATSE"), the Motion Picture Association of America, Inc., 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., and the National Association of Theatre Owners ("NATO") – collectively, the motion picture industry – respectfully file this comment in opposition to approval of the application of Media Derivatives, Inc. ("MDEX") for designation as a contract market ("DCM") under the Commodity Exchange Act, as amended, 7 U.S.C. § 1, *et seq.* ("CEA").

We will file a separate comment on MDEX's application for Commission approval of its Opening Weekend Motion Picture Revenue Contracts ("the MDEX Contracts"), which include binary options and collared futures. However, because the MDEX Contracts are the sole contracts MDEX seeks to trade, our comments on the merits of MDEX's application to be approved as a DCM will necessarily take into account its ability to satisfy the statutory criteria and core principles for registration as a DCM with respect to the MDEX Contracts.<sup>1</sup>

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<sup>1</sup> The MDEX Contracts are designed to provide a means to profit from bets on the box office receipts 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 receipts 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 receipts 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, therefore, 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 receipts, with any payouts based on receipts 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 one-quarter increments, from 0 to 100, and then multiplying by \$50.

MDEX has represented that it has received expressions of support for its applications for Commission approval of it as a DCM and of the MDEX Contracts, but as this comment reflects, the motion picture industry opposes both.

The designation of MDEX as a contract market is not warranted where, as here, its sole purpose is to provide a trading platform for instruments that do not constitute legitimate futures or option contracts, but are in essence wagers that are susceptible to manipulation. Rather than providing a real and useful means for hedging risk or price discovery, these instruments will be harmful and burdensome to the motion picture industry. Because MDEX, at a minimum, cannot demonstrate that it has the capacity to prevent market manipulation in MDEX Contracts, the ability to gather necessary information to police the market effectively and that such contracts are not readily susceptible to manipulation, MDEX cannot satisfy Designation Criteria 2 and 8 and Core Principles 3 and 4, and, therefore, the Commission may not designate MDEX as a contract market.<sup>2</sup>

**A. The Public Interest in Futures Trading Requires That Contracts Have a Real and Legitimate Economic Purpose and Use**

The only thing that distinguishes gambling wagers from legitimate futures contracts is that, as provided by Section 3(a) of the CEA, 7 U.S.C. § 5(a), the latter have legitimate economic purposes for commercial entities “by providing a means for managing and assuming price risks, discovering prices, or disseminating price information.”<sup>3</sup> CEA Section 3(b), 7 U.S.C. § 5(b), declares that it is the “purpose of this Act to serve the public interests described in subsection (a).”

This overarching public interest requirement is embodied in the CEA’s designation criteria and core principles requiring that a DCM prevent manipulation, in CEA Section 4(a)’s (7 U.S.C. § 6(a)) express condemnation of excessive speculation, and in its authorization of the Commission to prohibit such speculation. All of these features of the CEA constitute further unambiguous expressions of Congress’s intent that, for futures contracts to be lawful, they must have a real and legitimate economic purpose and use. The Commission’s oft-expressed standard that futures prices are required to reflect the “legitimate forces of supply and demand” similarly embodies the requirement that futures contracts have a legitimate economic purpose other than speculation. Further, the Commission’s express regulatory requirement with respect to DCM Core Principle 4 entitled “Monitoring of Trading” that the “designated contract market should collect data in order to assess whether the market price is responding to the forces of supply and demand” (Appendix B to part 38 of the Commission’s regulations) is founded on the statutory requirement that futures contracts both conceptually and as traded have a real economic purpose. The Commodity Futures Modernization Act of 2000 (“CFMA”) may have relaxed the procedures the Commission must follow when considering an application to become a DCM, and the procedures governing requests for approval. The CFMA did not, however, change the CEA’s requirement that futures contracts have an economic purpose and that they be used for that purpose.

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<sup>2</sup> CEA Section 5(b)(1), (2), (8) and (d)(3) and (4), 7 U.S.C. § 5(b)(1), (2), (8) and (d)(3) and (4).

<sup>3</sup> CEA Section 12(e), 7 U.S.C. § 16(e), expressly provides that “[n]othing in this Act shall supersede or preempt . . . any criminal prosecution under any Federal criminal statute.”

It is, therefore, incumbent upon any applicant for contract market designation by the Commission to show that the contracts for which it is seeking designation serve these public purposes of price discovery, managing price risks (*i.e.*, hedging), and disseminating valid pricing information. Further, consistent with the foregoing statutory requirements and Congressional intent, an application to become a DCM should be denied unless the applicant can demonstrate that any of the contracts it proposes to trade would in fact provide a means to shift risks and *would in fact be used* for hedging and price discovery.<sup>4</sup>

The MDEX Contracts cannot serve these public interests. They will not provide a means of shifting risk; they will not in fact be used for hedging and price discovery. Rather, they are simply a means by which MDEX seeks to serve its 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. Accordingly, MDEX's application for designation as a contract market should be denied.

**B. The MDEX Contracts Have No Legitimate Economic Purpose and Their Inherent Flaws and Susceptibility to Manipulation Cannot Be Cured by Contract Market Rules**

MDEX's Contracts are not useable for price discovery of an underlying product, will not be used for hedging, and are susceptible to manipulation by a single person or small group of persons. They are no different in kind from bets *before any deliveries occur* on how much wheat from one farm will be accepted for delivery in the market as meeting deliverable grade for one week, where the standard for deliverable grade wheat is based on subjective standards of taste and the bettor does not know the farm's acreage or the quality of its wheat. Such bets would have no legitimate economic purpose and would surely be disallowed by the Commission if anyone sought approval to trade in such contracts. The same should be true for MDEX.

There is no cash market in motion picture box office receipts; there are no buyers and sellers of such receipts. Accordingly, there is no supply or demand for box office receipts. Because no rights or interests are traded in motion picture box office receipts, motion picture box office receipts are outside of the legal definition of a "commodity." Indeed, in contrast to all existing futures contracts,<sup>5</sup> MDEX Contracts do not even relate to the valuation of a *traded* hard or intangible commodity.

Further, unlike all other futures and cash markets, there are no natural sellers of box office receipts that need to hedge against rising receipts – no person experiences risk of financial

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<sup>4</sup> We respectfully submit that the Commission's current proposed rulemaking to adopt hard, federal speculative position limits in certain energy contracts inherently recognizes that the CEA requires much more than a *theoretical* hedging use to sanction trading of a futures contract.

<sup>5</sup> The S&P 500 Index futures contract, for example, ties back to trading in the constituent securities of the index. Weather futures tie back to trading in commodities whose values can be affected by and correlated with weather patterns, such as natural gas, and thus they can be valued on the basis of their effect on the underlying commodity. Future crops of winter wheat are bought and sold in commercial markets in advance of their planting. The Consumer Price Index is used as a measure to adjust wages in numerous labor contracts and for various government payments to retirees, Social Security beneficiaries, etc. The proposed MDEX Contracts tie back to nothing at all.

loss by upward movements in box office receipts.<sup>6</sup> Because of the asymmetry of the market, MDEX Contracts would be readily susceptible to manipulation because there is no natural price competition between longs and shorts in an underlying commercial market.

**1. The MDEX Contracts would not provide any legitimate price discovery because they would be traded in an informational vacuum without any reliable economic grounding**

Because trading in MDEX Contracts would occur only for the first four weeks *preceding* a motion picture's release, traders generally will not have seen the motion picture they are betting on. And traders would not have access to much of the material information affecting a motion picture's first weekend box office performance (*e.g.*, marketing budgets, distribution agreements, private focus groups screenings), because it generally is not publicly available. Trying to forecast box office receipts without the benefit of the non-public information that is closely held by studios and other motion picture industry insiders is arbitrary and speculative.<sup>7</sup> Significantly, none of the means used to assess the legitimacy of futures pricing based on supply and demand would exist for the MDEX Contracts. During the four-week, pre-release trading period, 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.

The premise that "final" business decisions regarding motion picture marketing and distribution plans that affect box office receipts will have been made before trading commences is erroneous. Non-public business decisions affecting box office receipts can and do occur up to the release of the motion picture and afterward. 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.<sup>8</sup> The distribution plan for a motion picture (which is distinct from, though complementary to, the marketing plan) changes continually and is not final until the day of print shipment. State laws may also influence the distribution of a motion picture, because many states mandate offering a screening of a motion picture to all exhibitors in the state prior to commencing negotiations for any licensing deal and such a screening may not be available until a week or two before opening.

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<sup>6</sup> The Staff informed us that MDEX has admitted that there are no natural sellers of opening weekend box office receipts.

<sup>7</sup> 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 breakdown of spend by media are not public and would be difficult to determine as an outside observer, particularly as marketing varies by location.

<sup>8</sup> 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 opening weekend box office receipts.

## **2. MDEX Contracts would not be used for hedging**

None of the undersigned, or any of the distributors, or studios represented by the undersigned, intends to use an MDEX Contract for hedging purposes. The industry's opposition demonstrates there is no general call for this kind of financing mechanism; the studios have their own financing, or in the past have raised it through private investment, or have resorted to public financing. Moreover, there does not appear to be even a *theoretical* basis for a hedging use for the binary option. As to collared futures, the realities of the marketplace are that no commercial interests involved in the production, marketing or distribution of the motion picture will want to run the risk of negative publicity and characterizations that it was "betting against" the success of its own motion picture by "shorting" it, thereby undermining the public acceptance of it. For much the same reason, there is a concern that such transactions could generate claims of violating standard mutual covenants in industry contracts with exhibitors, directors, actors and others that prohibit disparagement of the work.

The potential for harm to the studios raised by the MDEX Contracts applies to directors in ways that are different in kind and degree. A director's investment in a picture is unique. Directors spend many years in the development, pre-production, production and editing of their motion picture, in collaboration with many other talented individuals. By virtue of the time and creative effort he or she puts into a picture, the director (and other motion picture artists who are intimately involved in the creation of the final work) has a great deal to lose if the picture's chances for success are maliciously undermined. Ultimately, the damage to the director whose work is harmed goes beyond the economic. From this perspective, it is impossible to imagine a director deciding to "short" his or her own picture in the final weeks before its release – 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. It is also worth noting that directors have no need to "bet the over" on their pictures because their personal services agreements often contain provisions rewarding strong performance at the box office, whether in the form of box office bonuses or profit participation, or both.

It is well understood in the industry that there is no fast and hard "formula" for success regardless of the hard work and talent involved – in fact success for any motion picture is never a foregone conclusion. That is the accepted risk that both those who finance motion pictures and those who create them recognize and undertake.

Further, no studios and other industry insiders who have the ability to materially affect the level of box office receipts will want to trade in the MDEX Contracts because any purported benefit from such trading is clearly outweighed by the potential exposure to the threat of strike suits for claims of manipulation from disappointed traders, as well as to Commission and Department of Justice investigations of claims of manipulation when complaints about futures pricing are received. Knowledge about a motion picture prior to its release may be closely guarded, but the number of those who possess that knowledge is very substantial. There are many individuals who have some form of "insider" knowledge (certainly a director does; another example would be motion picture editors, among numerous others) and the structure of the industry is such that many of them work on a free-lance basis from picture to picture and are not full-time employees. For that reason, the definition of who constitutes an "insider" would have to be quite broad in order to encompass the number and types of individuals who have material knowledge about a motion picture before its release. All of these persons would be subject to the same concerns of potential unwarranted, but very costly, exposure to legal proceedings.

It is a fiction to believe the “firewall” required by the MDEX rules for trading in the contract by insiders, such as members of the MPAA, provides a legitimate means to hedge. In fact, such a “firewall” would prevent informed trading for purposes of hedging. It is noteworthy that no other futures contract that has been approved by the Commission requires such a firewall for proprietary trading by commercial interests. Indeed, the novel requirement of one here only underscores that the characteristics of this contract are not those of legitimate futures contracts. The MDEX firewall requirement essentially requires that any trading by a studio must be left to persons who are unaware of material information within the studio that affects and would permit it to project box office receipts for any motion picture. Accordingly, the firewall prevents any informed trading for the purposes of hedging and requires instead blind trading without the ability to know the studio’s information that would be material to making hedging decisions. As a practical matter, any decisions by a studio to hedge any risk are cleared with senior management, who necessarily have intimate knowledge of all financial and contractual information relating to a motion picture.

**C. MDEX Does Not Have Sufficient Ability to Detect and Prevent Manipulation or Insider Trading**

Neither MDEX nor any organization that it may wish to engage can capably monitor the motion picture industry to prevent manipulation and price distortion of contracts based upon motion picture box office receipts. MDEX, the motion picture industry, and the Commission do not have the adequate resources to detect and deter potential manipulation. In the first instance, as described above at page 4, the complete lack of any legitimate economic measure of valid pricing before the Rentrak numbers are announced prevents any ability to even identify a manipulated price.<sup>9</sup>

Further, the potential box office receipts for a motion picture can be materially affected by individual industry participants in a variety of different ways that would be exceedingly difficult for MDEX to detect. Exhibitors who contribute to the Rentrak numbers could, either intentionally or accidentally, misreport their data.<sup>10</sup> A distributor could determine within the four-week period preceding a motion picture’s release to reduce or increase the number of theaters that would show the motion picture on the opening weekend. A distributor for a variety of reasons could determine to substantially reduce or expand its marketing budget, which can

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<sup>9</sup> The staff has advised us that the materials submitted by MDEX that have not been posted on the Commission’s website constitute non-public information and thus are not available for review. We assume some of those materials contain MDEX’s demonstration that it would be able to conduct meaningful surveillance to prevent and detect attempted manipulation and to take meaningful disciplinary action against manipulators. Because those materials are not accessible to us, we are at a disadvantage in commenting on them. However, we find it difficult to believe MDEX – or anyone – would have sufficient resources, means of detection, and enforcement authority to meaningfully prevent, detect and deter manipulation and attempted manipulation given the unique characteristics of the MDEX Contracts.

<sup>10</sup> Rentrak provides tabulations of box office receipts from the exhibitors that have agreed to provide that information to Rentrak. We understand that many exhibitors record box office receipts electronically and then provide the aggregate information to Rentrak through an electronic feed, but also that many exhibitors tabulate their receipts manually. 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 an opening weekend, as measured against the entire universe of box office receipts 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.

materially affect opening weekend box office receipts. A major exhibitor could determine to show the motion picture on smaller or larger screens, which can materially affect audience interest and capacity. We respectfully submit that MDEX has 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 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 pre-release rumor mills with respect to the quality of motion pictures. These range from reviews by members of the public who have attended screenings, 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 has leaked pre-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 MDEX Contracts would intensify any incentive to spread false rumors in a manner that MDEX could neither detect nor control.

MDEX's response dated March 26, 2010 to the MPAA's March 23, 2010 comment letter further underscores that it does not have the authority or capacity to monitor the market to detect and deter manipulation. Its response states that its ability to prevent manipulation will be based on the requirement that studios disclose their proprietary information regarding box office receipts where the exchange believes such information is necessary to investigate or deter manipulation. We respectfully submit that the exchange has no authority to compel the motion picture industry or other private institutions to disclose any proprietary information and no such authority can be conferred on it by or pursuant to the designation of MDEX as a DCM. Studios have always carefully guarded this highly confidential and sensitive information.

MDEX's rules fail to address compliance issues with insider trading proscriptions of the federal securities laws. Where a motion picture's first weekend box office success is material to the market value of its publicly traded securities, MDEX Contracts could function in a manner similar to securities futures. Motion picture box office receipts for the first weekend can impact the price of the stock of the studio that produced the motion picture or its parent and other affiliates. Also, the rise or fall of a small 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 a small company. MDEX Contracts thus could be used by insiders as surrogates for their companies' securities in order to profit from inside information. MDEX's rules fail to adequately anticipate or prevent this.

#### **D. The MDEX Contracts Will Harm the Motion Picture Industry**

MDEX should not be approved as a DCM where, as here, the contracts it will list and trade will be detrimental to the industry they ostensibly are created to serve. MDEX Contracts create a panoply of negative effects and risks for the motion picture industry *that do not now exist* – from actually creating conflicts of interest for studio employees and independent contractors by providing the means to bet against the success of the product to complicating motion picture financing by creating new, but false, unreliable, and non-economic valuations of a motion picture's success. The risk of depressed box office receipts is more pronounced with box office futures because futures pricing, although lacking any reliable economic basis, could nonetheless affect a motion picture's prospects by negatively affecting financiers' and audiences'

pre-release perception. Because the ultimate breadth of distribution can be revised up to the time of release and afterward, the MDEX market could affect distributors' ability to secure screens if the MDEX Contracts are perceived to be trading negatively. 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 box office gross.

Motion pictures slated to open in limited theaters (which can still involve openings in 600 or more theaters) and then broaden based on word of mouth could be ruined by futures pricing that casts it in the false light of a failed opening.

Approval of the MDEX 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 MDEX Contracts at great cost to them. It is problematic whether any prohibition on insider trading would need to take into account inside information held by insiders who are not subject to the control of the studios. There are many industry participants who have access to material, non-public information and could try to use that information to profitably bet on MDEX Contracts. These range from financiers and their advisors, potential distribution partners, exhibitors (who have a right to see a motion picture prior to licensing it in the U.S.), 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.<sup>11</sup>

Trading in MDEX 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 receipts. Similarly, a thief armed with critical inside information might use it to profitably trade in MDEX Contracts. Nothing in MDEX's publicly available materials concerning its satisfaction of DCM criteria and core principals begins to suggest how it will be able to detect and prevent such manipulative conduct. Given the rise of the Internet and other technologies, piracy is a growing threat to the motion picture industry. The Commission should not provide any additional incentives for motion picture piracy and stealing of intellectual property by approving MDEX's applications.

The MDEX Contracts also create legal risk and expense for an industry that does not intend to use the Contracts. Even if such a studio compliance system is designed and executed to perfection, it is possible that, at some point, the Commission or the Department of Justice would investigate a suspicion of possible manipulation of MDEX Contracts, causing large legal expenses for the industry, which does not want or intend to use the Contracts. 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.

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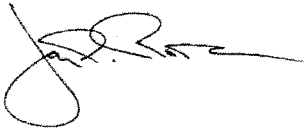
<sup>11</sup> Although certain members of the public may see a motion picture prior to its theatrical release, and their reactions may become public through social media and social networking technologies, much of this information remains non-public.



**E. Conclusion**

For the reasons set forth above, we respectfully and strongly recommend that the Commission deny the application of MDEX to become a DCM. We thank the Commission for its consideration of this comment letter. Please contact Greg Frazier of the MPAA, at 202-378-9107 or [Greg\\_Frazier@mpaa.org](mailto:Greg_Frazier@mpaa.org), if you have any questions or need further information.

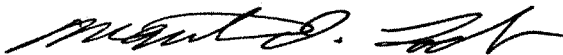
Sincerely,



Jay D. Roth,  
National Executive Director  
Directors Guild of America, Inc.



A. Robert Pisano,  
Interim Chief Executive Officer  
Motion Picture Association of America, Inc.



Matthew D. Loeb,  
International President  
International Alliance of Theatrical Stage  
Employees



Jean M. Prewitt,  
President and Chief Executive Officer  
Independent Film & Television Alliance



John Fithian,  
President and Chief Executive Officer  
National Association of Theatre Owners

cc: Chairman Gary Gensler  
Commissioner Michael Dunn  
Commissioner Scott O'Malia  
Commissioner Jill Sommers  
Commissioner Bart Chilton  
Mr. Richard Shilts  
Riva Spear Adriance, Esq.  
Jane H. Croessmann, Esq.