

**Written Testimony
of
Robert S. Swagger
Chairman and Chief Executive Officer
Media Derivatives, Inc.
Before the
House Committee on Agriculture,
Subcommittee on General Farm Commodities and Risk Management**

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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 Entrainment 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 2007-08, 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.

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

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 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

² Grain Futures Act, ch. 369, 42 Stat. 998 (Sept. 21, 1922). *See also*, 73 Fed. Reg. 25,669, 26,672 (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 recordkeeping 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.

A transparent market place 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.

VI. 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. 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 underperformance 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:

⁴ See Letter from Objectors to Chairman Gary Gensler, CFTC, dated March 23, 2010.

⁵ See CEA §§ 3(b) and 9(a)(2).

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;

⁶ CEA § 5(b)(2), 7 USC § 7(b)(2).

⁷ CEA § 5(d)(3), 7 USC § 7(d)(3).

- 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
- 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

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 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 USC § 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).

office results of Iron Man 2 or Date Night. This market is open to the public, 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.