

CALIFORNIA INSTITUTE OF TECHNOLOGY

DIVISION OF THE HUMANITIES AND SOCIAL SCIENCES 228-77

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April 29, 2010
House Committee on Agriculture
Chairman Collin C. Peterson
1301 Longworth House Office Building
Washington, D.C. 20515

House Committee on Agriculture
Ranking Member Frank D. Lucas
1301 Longworth House Office Building
Washington, D.C. 20515

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 economic 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.

April 29, 2010
Page 5

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 important 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