Securities

Deep Dive

DraftKings Suits Will Help Compare Hedging Tools With Gambling

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The sprawling legal battle over whether sports prediction markets should be regulated as gambling forums or financial marketplaces will see some guidance as new litigation against DraftKings Inc. invites a side-by-side comparison of the two ostensibly different products.

Differentiating the two will prove key as prediction market providers and the Trump administration clash with states, tribal authorities, and individuals on who gets to oversee the booming multibillion-dollar industry.

Some popular online sportsbooks like DraftKings, which prediction market platforms have worked to differentiate themselves from, have started wading into prediction market offerings. DraftKings drew fire over the last week in a trio of lawsuits brought by users, most of whom lost money, accusing it of foraying into prediction markets to operate in states where sports betting is illegal such as California, Texas, and South Carolina.

The allegations mirror those against other prediction market platforms: These offerings are glorified sports betting designed to circumvent state laws under the guise of financial trading regulated by the Commodity Futures Trading Commission.

Prediction markets allow people to put money down on yes-no outcomes for a wide range of public events — if the Red Sox prevail in Friday's MLB game, if there will be more tech layoffs this year than last, if Rep. Max Miller (R-Ohio) will drop his reelection bid. Operators like Kalshi Inc., with the backing of the Trump administration, say that their sports and other event contracts are hedging instruments called swaps under the CFTC's exclusive jurisdiction, and that the federal law designating its authority preempts states' regulations.

States, which were able to legalize sports betting nationwide after a 2018 Supreme Court ruling, argue that these offerings are wagers subject to their regulation.

Prediction markets and the CFTC of late have taken a thrashing in courts, with federal judges in Wisconsin and Utah denying preliminary injunctions shielding the companies, saying the federal Commodity Exchange Act doesn't preempt the states' gaming enforcement. Judges have been skeptical of the line between sportsbooks and prediction markets, and the DraftKings litigation could provide a clear comparison, attorneys say.

The sportsbook vendor, which launched its prediction market app late last year, drew three suits in the past two weeks brought by individuals saying that they were lured into using its DraftKings Predictions, which amounts to an unlicensed sportsbook.

"It's a little different when you bring up an example directly from one company where you have basically both and they're both sports," said Seward & Kissel's Kris Swiatek, a partner in the firm's investment management and digital assets groups. "That brings a whole deeper level of analysis because then you're not comparing theoretical event contracts to sportsbooks. You are literally comparing this company's ability to do both and then unpacking that and saying, 'What are the real differences between these two?'"

Class Suits

There are two main differences with the initial DraftKings suit, a proposed class action, compared to other prediction market litigation, said Cahill Gordon & Reindel LLP derivatives partner Gary Kalbaugh: It's the first involving a hybrid gambling and prediction market company, and it argues that both forums allow users to achieve the same end.

"We can understand how that can be superficially attractive. People say, 'Well, it's the same app I'm on,'" he said. "But we also see that on my bank's app: I can do a variety of activities."

The comparison could benefit the company in the end, and perhaps boost the CFTC and prediction markets' arguments if a judge swings toward DraftKings.

By offering both kinds of products, "it sort of creates this image that the defendant really is trying to circumvent the law. But this is an optics thing," said Schlam Stone & Dolan LLP managing partner Jeffrey M. Eilender, who specializes in commercial litigation. "In terms of the merits, I don't think it makes the defense harder or makes it easier for the plaintiff."

But the debate's also playing out in the public and before lawmakers, where there could be broader impacts. "And there I think you have the ability to potentially create legislation or change policy at the governmental level, which is different from evaluating whether what they're doing is legal under a court proceeding that looks at existing law," said Brian Sung, co-chair of Haynes Boone's derivatives practice group.

A DraftKings spokesperson said in a statement that the company is confident in its legal position.

"DraftKings' prediction markets offering operates in accordance with applicable law and the federal regulatory framework established under the Commodity Exchange Act," a spokesperson said in a statement.

State Litigation

Many state gaming regulators have said licensed sports betting operators that get involved with prediction markets may jeopardize their license. DraftKings last year withdrew its pending sports betting license applications in Nevada.

The complaints say that the company decided to set up prediction markets in states where sports betting is illegal, supposedly to avoid litigation "that has tied up the other prediction market platforms," Sung said.

Prediction market litigation involving regulators has mostly occurred in states where sports betting is legal, with states saying the operators are offering wagering without a license.

The company is partially insulated because while DraftKings does have a CFTC-designated contract market, that's not what it's using for the entity at the center of the suits, Kalbaugh said.

"The fact that they're using an introducing broker kind of insulates them from a lot of litigation," at least from the states themselves, he said, because by and large the states' dispute has been with the designated contract markets.

DraftKings also has a leg up given its experience with litigation over daily fantasy sports, which has also been targeted as illegal sports gambling.

"All of these things, they have a lot of recent experience on," Kalbaugh said. "And I think they're going to leverage that."