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TRADING ON INTEGRITY: THE FORTHCOMING RECKONING FOR SURVEILLANCE IN PREDICTION MARKETS

Prediction markets have gone mainstream, and concerns around insider trading and manipulation have come under sharper focus. As these markets mature, so too must the surveillance frameworks that govern them. Where traditional derivatives surveillance asks whether trading distorted a price, prediction markets pose a more challenging question: did the trader merely forecast the event, or did the trader know, control, or influence the outcome? This paper terms that problem “outcome agency risk” and argues that it is the central reason these markets cannot simply borrow the playbook of traditional derivatives if prices are to remain a credit measure of honest judgment about the future.

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I. INTRODUCTION

Prediction markets have gone mainstream. Retail-facing trading venues offering event contracts enable market participants to trade on elections, sports, economic releases, corporate events, cultural outcomes, and other real-world contingencies. This explosion in popularity has also drawn increased scrutiny. Each week, there are several articles about alleged insider trading and market manipulation. Needless to say, these markets and the potential for market manipulation in them have captured public attention. How these markets respond to this scrutiny and whether they can develop credible, durable solutions to address these concerns, will be a defining moment for the industry.

Surveillance in prediction markets differs from surveillance in traditional derivatives markets. A conventional surveillance program in trading derivatives markets monitors whether trading activity distorts the price of a contract or the market for an underlying commodity. Prediction market surveillance must ask a harder question. Did the trader merely forecast the event, or did the trader know, control, or influence the outcome? This paper refers to this problem as “outcome agency” risk because the trader may have agency over the outcome itself, not just information about it.

This paper begins with explaining the mechanics and regulatory setting of prediction markets, tracing the development of event contracts from an academic

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