Regulatory Oversight Podcast — From Vegas to Venezuela: High-Stakes Predictive Markets
Host: Stephen Piepgrass
Guest: Lu Reyes
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Stephen Piepgrass (00:03):

Welcome to another episode of *Regulatory Oversight*, a podcast dedicated to delivering expert analysis on the latest development shaping the regulatory landscape. I'm one of the hosts of the podcast, Stephen Piepgrass, and I lead our firm's Regulatory Investigation Strategy and Enforcement, or RISE, practice group. Our podcast highlights insights from members of our practice group, including our nationally-ranked state attorney's general practice, and we include guest commentary from industry leaders, regulatory specialists, and current and former government officials. Our team is committed to bringing you valuable perspectives, in depth analysis, and practical advice from some of the foremost authorities in the field today. Before we begin, I want to encourage our listeners to visit and subscribe to our blog at regulatoryoversight.com to stay current on the latest in regulatory news.

As many of our listeners know, I specialize in regulatory compliance and investigations, and one of the areas in my portfolio is gaming. A significant focus of mine this past year has been advising clients on the rapidly growing predictive market space, which has been challenged by a number of states as an end run around regulations around traditional gambling. Today, I'm joined by my partner, Lu Reyes, to discuss the ramifications of a recent headline-grabbing trade in the predictive market space that appeared to anticipate former Venezuelan President Maduro's capture. As I mentioned, Lu is a partner in our RISE practice group, but before he joined us and before he got into private practice, he was also a senior government official having served as Deputy Assistant to President George W. Bush, where he acted as an advisor to the President and a member of the White House senior staff. In that role, Lu advised President Bush on national security policy matters. He also served as Deputy Associate Attorney General at the U.S. Department of Justice.

Lu, thank you for joining me today to talk about what I think is a really fascinating topic.

Lu Reyes (02:01):

Thank you, Stephen. It's a pleasure to be here, and I appreciate the time.

Stephen Piepgrass (02:05):

I want to set the stage for our listeners, but before I do that, I just want to ask you a little bit about your bio. I know you served in the Bush White House, as I noted at the beginning. Tell me a little bit about that, and particularly the perspective that you can bring on this issue that seems to implicate national security, potential DOJ investigation, authority, all sorts of different issues that I'd like to be able to draw on some of your background to discuss.

Lu Reyes (02:33):

Sure. I think my beginning of my education on national security began on September 11th when I was at the Justice Department in the Civil Division. And from that time on, I worked on national security issues. Specifically at that point, we were establishing protocols that would hopefully prevent such attacks from happening again, but also reviewing and understanding how classified systems worked and making sure those were as strong as possible in terms of the protections. But after that, I did go over to the White House and I had the national security portfolio for President Bush as it related to selection of human capital to serve in high-ranking positions from the Cabinet on down. But that inherently did require a very solid and strong understanding of national security policies, national security mechanisms, threats, vulnerabilities, and of course, programs.

And then after that, I served as a general counsel for one of the few US government agencies with an international law enforcement dimension, which was the Special Inspector General for Iraq Reconstruction. But again, at the heart of the work was protecting US classified information through external investigations and audits of organizations and individuals that could unfortunately sometimes lapse in keeping that information. So that's a little bit of my exposure to this world.

Stephen Piepgrass (04:04):

That's great, and now our listeners know why I thought this conversation could be really interesting. So I'll set the stage just a bit for those who haven't seen the news stories on the predictive markets trade. Shortly before Maduro's arrest in Venezuela, apparently a trading account was opened with Polymarket and about $30,000 or so was deposited in the account. A number of trades were made in that account, all surrounding current events in Venezuela and a number that seemed to be connected to predictions that Maduro would no longer be the president soon, and the one that probably raised the most eyebrows was a trade saying that he would be no longer president of Venezuela by the end of January of 2026. And of course, that came to be true shortly after that trade was made, and the trader, who no one knows who the person is, made about $400,000 on that trade.

So for obvious reasons, there's been a lot of conversation around insider trading and the national security ramifications of this. So as I mentioned at the beginning of the podcast, I've actually been working in this space with predictive markets for quite some time now, advising clients as they're thinking about the ramifications of this new market that's opened up. And so just a little bit of background for our listeners, the CFTC ... Although I'm guilty of using this shorthand as well, I often say there's no real enforcement mechanism in the CFTC for insider trading, that's actually not accurate. The CFTC does have rules and regulations and they are able to enforce for fraud, including insider trading. The issue is that the CFTC only has about an eighth of the staff of the SEC, which is the traditional enforcer for traditional markets when it comes to insider trading.

And then making it even more difficult for the CFTC to do any sort of real enforcement activity around insider trading is the fact that with these new predictive markets, number one, persons who want to open up trade accounts are able to do so anonymously. And then number two, deposits into and payouts from those accounts are often in cryptocurrency, making it virtually impossible to trace those trades. And therefore, for all intents and purposes, even if there are rules around insider trading, it can be very difficult, if not impossible, for the CFTC to enforce those.

Both Kalshi and Polymarket, the two biggest predictive markets trading platforms, have some rules around insider trading, but then there have been various statements made, particularly by Polymarket's leadership, about the fact that Polymarket is made to create a financial incentive for people to divulge information to the market. That's really the purpose of these platforms. With that being the case, obviously there are all sorts of issues around enforcement, particularly on insider information.

And so, one of the issues I thought I'd like to talk about with Lu is, if we assume that it's going to be very, very difficult, if not impossible for CFTC to bring any sort of action, if it turns out that the person who made this trade ... And this is of course speculation on our part. We don't know who that person is or whether they actually had any inside information or not. But if it turns out that person is someone in a very narrow circle of people who had information about this military action about to be taken, Lu, what mechanisms are there in the government for investigating something like that? And what sort of punishments might be involved if, again if, the person were in a position where they had access to this information and then traded on it?

Lu Reyes (07:56):

That's a great question, Stephen. I think to your point, there are two pieces to this, which is what could happen, but also the difficulty in uncovering who the person was or unmasking, given the anonymity that is part of these markets. But the federal law does prohibit, of course, the leaking of classified information. And so in terms of the investigation piece, to the extent that there are limited and very well-documented amount of people that have this information, that's where the investigation begins. Who knew about this and what was their behavior? The problem you get into, of course, is whether or not there may be other people outside the United States, partners in Venezuela, who knows where, that may have been privy to this information, and then tracking down that kind of thread of a chain of a transfer of information.

So it gets tough, and it gets particularly tough where you have anonymity, as mentioned. But the US has incredible intelligence capabilities, and to the extent they can discover who it is, they would be subject to federal criminal law. And depending on how it happened and the facts surrounding intentionality, it could be potentially serious. That really does underscore the incredible seriousness of the protection of classified information. We're talking about information that if leaked can cost American lives, that if leaked can create financial incentives for others to acquire classified non-public intelligence. I could go onto that when you're ready, but I think there are several ramifications that are implicated here.

Stephen Piepgrass (09:45):

I think that's a great point. Lu, I think one of your observations was, we're speculating as to who may have known and whether this person actually had inside information who placed this bet. There are other potential explanations. For example, observers have seen that pizza orders around the Pentagon have increased before military action. Maybe someone noticed that and made this kind of a bet. But setting those possibilities aside, one of the things that this seems to do is create potentially a whole new class of spy who is interested not in geopolitical gain for their country or whatever interest group they may represent, but personal financial gain. Can you speak to that a little bit, Lu?

Lu Reyes (10:27):

Yeah, that's exactly right. When markets allow trading on geopolitical, military, or government decision outcomes, they're effectively putting a cash bounty on secrets. This can encourage attempts to penetrate government planning processes, hack into decision systems, recruit insiders, do all kinds of things by actors that normally wouldn't be a part of the geopolitical spectrum, but these would be actors that are just solely sinking financial incentives, financial gain. And that undermines, of course, core national security protections.

And then there's the flip side to that coin, which is the government officials, intelligence analysts, the defense contractors, diplomats, military personnel, they could be tempted now to trade themselves for very direct and immediate financial gain through anonymous means. They could leak information to proxies or just outright sell the intelligence. Even when not framed strictly as insider trading, this can easily cross into espionage violations, violations of classified information laws, and clearly criminal misconduct. So, monetizing knowledge that must remain protective really increases temptation, opportunity, and risk.

And there's one other piece, Stephen, if I may, that this does, is all of a sudden you have a market out there that's basically wagering on outcomes, or actions rather, by the government. And when you have markets that become visible measures of, quote-unquote, "what is expected," it could risk influencing events rather than merely just forecasting them.

Stephen Piepgrass (12:13):

Yeah, and that is a trip down the rabbit hole that I thought we might actually want to take. So why don't we? This is a little bit of a Tom Clancy novel or David Baldacci novel, but what we're really talking about here is the fact that if it's possible to anonymously trade like this and make very large profits off of it, it is at least theoretically possible that persons who have the ability to actually push an event forward can also trade on that event itself. And it creates pretty scary incentives to move an action forward that might not otherwise move. Obviously, all of that is complete speculation on our part, but it's certainly a risk that, that's probably something that folks in the White House are thinking about right now, and probably in Congress as well. Would you agree with that, Lu?

Lu Reyes (13:04):

Yeah, absolutely. It could turn things on its head. Quite honestly, I mentioned earlier about costing lives, the other dimension to this is it can be a source of foreign intelligence gathering. Say the insider had made this bet 24 hours before the strike and the Venezuelans got word of it and were ready for the attack. So it is fraught with peril on all sides. Yeah, couldn't agree more, Stephen.

Stephen Piepgrass (13:35):

Yeah. A couple of additional thoughts about this. One is, people have been talking a lot about predictive markets, and the vast majority of the courts that have looked at this and the states that have tried to take action in this space, it's all been around sports betting. But what this really shows is, predictive markets are much, much broader than just that. And then you combine that with this potential disparity of information around the people who are trading in it, trading in these markets, that's something consumers actually aren't thinking about, in large part because of the focus of the regulators on trying to blur the line between traditional betting and predictive markets. In fact, there is a significant difference between the two, and that big difference is there are people who are able to trade in these markets that have information that others don't. So it's not the same regulated level playing field that your traditional betting offers when you're talking about real money gambling in a licensed way.

Lu Reyes (14:37):

Correct. I couldn't agree more. The fundamental paradigm difference between wagering on something that an outcome has not been determined, and trading on information that some humans may already have, you couldn't get more distinct.

Stephen Piepgrass (14:52):

One other very interesting piece that's come out of these trades around Venezuela is the fact that there were a number of "bets" placed, and I'll use bets with quotations around it, trades, around the question of whether the US will invade Venezuela by a certain date. And after this military action took place in Venezuela, the question arose, "What's invade really mean?" Polymarket has adopted a definition, it sounds like, of invading meaning if the US commences a military offensive intended to establish control over any portion of Venezuela by whatever the date certain was that the prediction was made. But that post-hoc adoption of a definition also raises questions because obviously there are incentives for Polymarket to adopt a fairly narrow definition, and for the better to adopt a broad definition of invade. I think that just illustrates one more way in which these predictive markets really do differ from traditional gambling. Sometimes decisions can be made after the fact in these markets that have real money implications for the consumers who are trading in them.

Lu Reyes (16:05):

I couldn't agree more, Stephen.

Stephen Piepgrass (16:07):

So I think the last piece I want to cover is, where do we go from here? We've talked a good deal about things that might be concerns for regulators, for Congress, for the administration. Any thoughts on that, Lu, as government really starts to try to get its arms around these new predictive markets?

Lu Reyes (16:28):

This is actually a very good case study, and quite honestly, the United States is lucky that the market didn't tip off the foreign adversaries in this case. But all the elements were there for this to be a very bad outcome for US intelligence, US lives. So without creating committees for committees' sakes, there needs to be a study in depth of the full dimensions to this, how protective markets, especially when they interact with geopolitical predictions, how they should be looked at and treated. We have very clear laws in the United States that protect classified information that is ultimately in the best interest of the United States and those who are protecting it. Those same underlying tenants could be the basis for enacting new additional legislation that may affect predictive markets or how they are actually run in the United States.

Now, it is much easier said than done. A lot of these markets, they don't have to necessarily be in the United States, but at some point, there needs to be a review of whether or not the penalties right now for getting into this type of trading of potentially classified information are adequate. So that's a place to start.

Stephen Piepgrass (17:49):

Yeah, and I don't want our listeners to think that we're anti-predictive markets in this. In fact, my guess is, I don't have any inside information on this, but my guess is this is something that the predictive market operators, the platform operators, are thinking about too. They have an interest in making sure that these markets are well regulated. And in fact, that's what they're doing in these cases is they're really asking, "CFTC, we want to be regulated by you. We're glad we're regulated by you. What do we need to do to make sure that this is a safe new market for consumers to participate in?" I think what our conversation today highlights is, the concerns around this are much broader than probably that conversation to date has covered.

So far, so much of what we have talked about when it comes to predictive markets is the comparisons to the gaming space. And so, thinking about how do we make sure that people can self-exclude if they need to? How can we make sure that there is appropriate age limitations on participation? And things like that, the same sorts of traditional questions that have been around gaming for many years. And that's been the focus of regulators and that's been the focus of the conversation so far. I think what our conversation today has shown me, Lu, is actually that conversation needs to be broader. We need to think about this much more comprehensively if we want these markets to remain open and for this to continue to be a really robust and vibrant part of the economy.

Lu Reyes (19:23):

Yeah, I couldn't agree more, Stephen. I would say that the predictive markets themselves, as you said, would be the number one champions of making sure that classified information or inside information is not used. Otherwise, the markets themselves ultimately will cease to exist. So agree, not against predictive markets, but using the classified or insider information to unlevel the playing field is not good for them or the consumers.

Stephen Piepgrass (19:57):

Lu, thank you very much. This has been a really great conversation, probably a little bit different from most of the conversations around regulatory activity that our listeners are used to hearing, but one I hope not just those who are on our normal mailing list, but others who are interested in these sorts of issues find entertaining as you listen to our podcast. So Lu, I want to thank you again for joining me today. It's been a great conversation. And I also want to thank our listeners for tuning in. Please remember to subscribe to our podcast using Apple Podcasts, Google Play, Stitcher, whatever platform you choose, and we look forward to having you join us again next time.