Prediction markets and regulation in the BVI: gaming, betting or investment business?

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Introduction

Prediction markets have become an increasingly prominent part of the digital asset and decentralised finance landscape. In simple terms, they allow participants to take positions on whether a particular future event will or will not occur. Depending on the platform, that event might be the outcome of an election, a sporting event, a decision by a central bank, the release of economic data or almost anything else capable of being objectively and definitively determined.

The concept itself is not particularly new. Betting markets have long allowed participants to speculate on future events, and financial markets routinely allow investors to take positions on future movements in prices, rates and indices. What is different about many newer prediction markets is the technology through which they operate and the considerably wider range of events on which markets can be created.

Blockchain technology has made it possible for prediction markets to operate using smart contracts, digital assets and decentralised infrastructure, potentially without the traditional bookmaker, exchange or other intermediary sitting at the centre of the transaction.

This in turn creates an interesting regulatory question. A prediction market may look economically similar to traditional betting in some respects and to a financial derivative in others. In some cases, it may potentially be both.

For businesses proposing to establish or operate prediction markets using a British Virgin Islands ("**BVI**") company, two pieces of legislation require particular consideration: the Virgin Islands Gaming and Betting Control Act, 2020 (as amended) (the "**Gaming Act**") and the Securities and Investment Business Act, 2010 (as amended) ("**SIBA**"). We will also briefly consider whether the regulatory regime under the Virtual Assets Service Providers Act, 2022 (as amended) ("**VASP Act**") might also be relevant to prediction markets.

How do prediction markets work?

The precise structure varies between platforms, but the concept is relatively straightforward. A market is created around a future event with an objectively determinable outcome. Participants then acquire positions which derive their value from that outcome. A simple example might be a market asking whether a particular candidate will win an election. A participant who believes that the candidate will win takes one position whilst another participant may take the opposite position. Once the result is known, the contract settles according to its terms.

The use of blockchain technology can allow the creation, trading and settlement of those positions to take place through smart contracts, with participants transacting using digital assets.

While it is tempting to assume that this necessarily makes the arrangement a form of gambling, given the apparent commercial similarities with traditional bookmaking, the legal analysis is more nuanced. Legislation does not generally ask whether an activity resembles gambling in a commercial sense. It instead defines particular activities and products and regulates those falling within those definitions.

The starting point is therefore to consider what the participant is actually acquiring or participating in, what event determines its value and what role the platform (and any BVI entity forming part of it) play in creating, operating or facilitating it.

Gaming & Betting

The Gaming Act establishes the principal statutory regime governing gaming and betting activities in the BVI. Section 29 of the Gaming Act prohibits persons from participating in the following aspects of the gaming and betting sectors without the necessary licence:

- owning or operating a gaming machine location for the purpose of conducting gaming;
- performing a specific function in connection with a licensed betting or gaming activity or in relation to a licensed premises;
- manufacturing, fabricating, assembling, programming, modifying or repairing equipment;
- selling, importing, supplying or distributing a gaming machine or associated equipment;
- leasing gaming machines to an owner or operator of a gaming machine location in exchange for remuneration based on earnings in profit from a gaming operation;
- manufacturing, selling, supplying, installing and adapting gaming software;
- providing facilities for betting of any kind; and
- providing or utilising premises for the purpose of gaming or betting.

The legislation is therefore not concerned only with traditional bookmakers or casinos. The legislation may also capture entities providing the infrastructure through which regulated gaming or betting takes place

The starting point for a prediction market is whether the underlying activity constitutes “gaming” or “betting” (as defined) for the purposes of the Gaming Act.

“Gaming” is defined as playing “*a game, whether on the computer, by electronic means, the internet or otherwise for a prize or winnings in money or money’s worth and includes but is not limited to lottery, raffles and scratch cards*”. A conventional prediction market, where participants simply take positions on whether an external event will occur, would not obviously involve the 'playing of a game'. The fact that money may be won or lost does not, by itself, necessarily make the activity "gaming" under the Gaming Act.

The position concerning betting is more complicated. The Gaming Act defines "betting" as "*making or accepting, on a fixed odds or pool betting basis, a bet on the outcome of a horse race or a sporting event or lottery draw, whether or not the same is carried out electronically or via the internet*". On a literal reading of that definition, its scope is considerably narrower than the ordinary, everyday meaning of 'betting'.

A prediction market concerning the winner of a football match or horse race may therefore fall readily within this definition. Conversely, a market concerning whether a central bank will reduce interest rates, whether a particular candidate will win an election or whether a company will announce a particular transaction does not appear, on the face of the definition of "betting" within the Gaming Act, to fall within it, even though, instinctively, one might expect it to. Conceptually (and financially), there is little difference between 'betting' $100 on the outcome of a horse race or the same amount on the outcome of an election. The financial risk and the process are the same. It therefore seems odd that one is potentially caught by the Gaming Act but the other is not.

There is, however, an important complication in the drafting of the Gaming Act. It separately defines a "betting transaction" as "*the making and accepting on a fixed odds or pool betting basis between a bookmaker or a promoter and a punter or bettor on the outcome of **<u>an event</u>**, horse race or lottery draw, whether or not the transaction is carried out by electronic means or via the internet*" (emphasis added). Unlike the definition of "betting", this definition is not expressly confined to horse racing, sporting events or lottery draws.

The distinction is potentially significant because the Gaming Act uses the expression "betting transaction" independently in some operative provisions. For example, Section 72 of the Gaming Act imposes restrictions on the use of premises for effecting or facilitating betting *transactions* without the appropriate licence.

The legislation therefore contains an apparent tension. Its general definition of "betting" is confined to specified categories of events which are narrowly defined resulting in an arbitrary regulatory treatment as noted above, whilst the separately defined concept of a "betting transaction" is capable, on its wording, of extending to 'an event' more generally. Significantly, both definitions were replaced by the *Virgin Islands Gaming and Betting Control (Amendment) Act, 2021* and the distinction was retained.

It would therefore be unwise to assume that a prediction market concerning a non-sporting event necessarily falls outside the Gaming Act. While such a market does not appear to fall within the narrower definition of "betting", it may nevertheless fall within the broader definition of a "betting transaction", which expressly refers to the outcome of an "event". The application of the Gaming Act will therefore depend on the particular structure of the market, including whether it involves fixed-odds or pool betting and the role performed by the relevant operator.

Jurisdiction and BVI companies

A separate but related question is whether the Gaming Act applies merely because an entity involved in the structure is incorporated in the BVI but where its operations are conducted outside of the BVI.

The Gaming Act does not contain an express provision deeming all gaming or betting activities conducted outside the BVI by a BVI company to be conducted within or from within the BVI. A contrast can be drawn with SIBA in this respect, which does contain such a provision. In the absence of an equivalent deeming provision, the jurisdictional analysis will instead require consideration of matters including where the relevant activities take place, where any facilities are provided and the functions actually performed by the BVI entity.

Businesses using BVI companies within international prediction market structures should therefore avoid assuming either that BVI incorporation automatically brings all activities within the Gaming Act or, conversely, that conducting the platform and its activities outside the BVI necessarily resolves the issue. This is an area where guidance from the Gaming and Betting Control Commission would, once it becomes operational, be welcome.

SIBA

Even where a prediction market falls outside the Gaming Act, or where its application is uncertain, SIBA requires separate consideration.

SIBA prohibits a person from carrying on investment business in or from within the BVI without the appropriate licence unless an exclusion or exemption applies. As noted above, a BVI business company which carries on "investment business" outside the BVI is deemed for these purposes to carry on that business from within the BVI.

There are two separate questions. First, does the contract or token traded through the prediction market constitute an "investment" for the purposes of SIBA? Secondly, if it does, is the relevant BVI entity undertaking an activity in relation to that investment which constitutes regulated investment business?

SIBA contains specified categories of investments rather than simply regulating anything acquired with an expectation of financial return. Options, futures and contracts for differences ("**CFDs**") are among the categories of investment potentially relevant to prediction markets.

Most conventional prediction market contracts would not naturally constitute options or futures as they do not typically confer a right to acquire or dispose of an underlying asset or provide for the future delivery of property. The position concerning CFDs is more interesting.

The expression "contract for differences" might ordinarily suggest a conventional financial derivative under which parties obtain exposure to movements in the price of an underlying financial asset without acquiring that asset. The definition under SIBA is broader. SIBA's definition includes "*any other contract the purpose or intended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in – (i) the value or price of property of any description; or (ii) an index or* ***<u>other factor</u>*** *designated for that purpose in the contract*" (emphasis added).

The reference to 'other factor' is significant for prediction markets. Returning to the above example of a binary market concerning whether a particular candidate will win an election, there is at least an argument that the occurrence (or non-occurrence) of that event constitutes the 'other factor' designated in the contract by reference to which a profit is secured or a loss avoided.

The same issue potentially arises in markets concerning interest-rate decisions, economic data, corporate events, sporting results and numerous other binary or other objectively ascertainable events.

This does **not** mean that every prediction market contract will necessarily constitute a CFD under SIBA. The statutory definition must be applied to the precise legal and economic characteristics of the relevant contract. It does, however, mean that the SIBA analysis should not be confined to prediction markets concerning traditional financial products only, as its remit is demonstrably broader.

Somewhat counter-intuitively, a prediction market concerning an election may therefore raise a potentially more difficult question under SIBA than under the Gaming Act. The fact that the underlying event is political, sporting or otherwise unrelated to conventional securities does not, by itself, determine whether the contract is an investment.

Operating the Platform

Establishing that an event contract constitutes an investment is only the first part of the SIBA analysis. It is then necessary to consider what the relevant BVI entity actually does in relation to that investment.

Particular care is required where the arrangements could amount to operating an investment exchange. SIBA defines this as "*providing a facility, whether by electronic means or otherwise, for the orderly trading of investments or for the listing of investments for the purposes of trading, by members of the investment exchange"*.

If the contracts traded through a prediction market constitute 'investments' (such as a CFD) and the platform itself satisfies the above definition, the operation of the platform may therefore require an investment business licence.

Whether that is the case will depend upon the mechanics of the particular platform. The fact that buyers and sellers interact through smart contracts rather than a conventional order book does not, by itself, avoid or answer the question.

Nor does describing a platform as "decentralised" determine its regulatory treatment. The relevant analysis remains focused on the persons involved and the functions they actually perform. Where identifiable persons continue to control the user interface, smart contracts, admission of markets, liquidity or other important aspects of the platform, their activities need to be considered individually against the categories of investment business prescribed by SIBA.

VASP considerations

Prediction market platforms operating using digital assets should also consider whether the Virtual Assets Service Providers Act, 2022 (as amended) ("**VASP Act**") applies to any activities conducted by a BVI entity. Depending upon the structure, activities involving the exchange, transfer or custody of virtual assets would likely constitute a regulated 'virtual asset service' within the meaning of the VASP Act.

The analysis of whether the VASP Act applies should, however, be undertaken alongside SIBA rather than in isolation. In particular, the statutory definitions contain exclusions intended to distinguish virtual assets from certain traditional financial products regulated under existing BVI financial services legislation. Accordingly, whether a prediction market contract constitutes an "investment" under SIBA may also be relevant to determining its treatment under the VASP Act.

The use of blockchain technology or digital assets within a prediction market does not, of itself, make it a VASP. As with SIBA, the relevant question is what activities the BVI entity actually performs and whether those activities fall within the statutory definitions.

One platform but different regulatory outcomes

The regulatory treatment of prediction markets under BVI law is consequently less straightforward than the label "prediction market" might suggest.

A market concerning a sporting event may potentially engage the Gaming Act. Depending upon its structure, the same contract might also require consideration under SIBA.

A market concerning an election or other non-sporting event does not appear to fall naturally within the Gaming Act's definition of "betting", although the broader definition of a "betting transaction" prevents the position from being treated as entirely straightforward. At the same time, the breadth of the CFD provisions under SIBA means that the contract may potentially constitute an investment even though its subject matter has nothing to do with a conventional financial market.

The analysis therefore cannot safely be undertaken simply by asking whether a business operates a prediction market. Instead, consideration should ordinarily be given to:

- the event or other factor by reference to which the contract settles;
- whether the arrangement operates on a fixed-odds, pool or other basis;

- the legal and economic characteristics of the contract or token acquired by the participant;
- whether the contract falls within one of the categories of investment under SIBA;
- how contracts are created, traded and settled;
- whether participants transact with the platform itself or with one another;
- the functions performed by each BVI entity involved in the structure;
- whether the platform provides or controls liquidity; and
- where the relevant entities, activities and participants are located.

These issues become particularly important for platforms which permit users to create their own markets. A platform whose initial markets do not fall within a particular regulatory regime may not necessarily remain in that position if users can subsequently create contracts which change the regulatory analysis. Operators of such platforms should therefore consider appropriate controls over the markets that users are permitted to create, so as to reduce the risk of the platform inadvertently straying into regulated territory without the required licence.

Conclusion

Prediction markets are a good example of new technology having to operate within legislation that was not necessarily drafted with the particular business model in mind.

Of course that does not mean that there is a regulatory vacuum. The Gaming Act, SIBA and the VASP Act provide existing frameworks through which the activities can be analysed. However, none of the regulatory regimes we have considered regulate prediction markets as a category in their own right and the outcome therefore depends upon the characteristics of the individual market and the functions performed by the persons involved.

For operators, developers and other businesses using BVI structures, the regulatory analysis should therefore be undertaken at the level of the individual product and activity rather than by reference to the label attached to the platform. Blockchain technology may change how a prediction market is created, traded and settled. It does not, by itself, determine how that market is treated under BVI law.

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