Prediction markets and Cayman Islands regulation: gambling, 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 Cayman Islands ("**Cayman**") company, two pieces of legislation require particular consideration: the Gambling Act (2016 Revision) (the "**Gambling Act**") and the Securities Investment Business Act (2020 Revision) (as amended) ("**SIBA**"). Where the platform operates using virtual assets, the Cayman virtual asset regulatory regime may also require consideration.

We have previously considered the position in the British Virgin Islands whose laws differ from the Cayman Islands in many respects. You can find our previous article here.

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.

Gambling & Betting

The Gambling Act is considerably older than the technology underlying modern prediction markets and approaches gambling differently from the equivalent legislation in a number of other jurisdictions.

"Gambling" is defined as playing "*at any game, whether of skill or chance, for money or money's worth*". A conventional prediction market, under which participants simply take positions on whether an external event will occur, would not obviously involve the playing of a "game" as such. The fact that money may be won or lost does not, by itself, necessarily make the activity "gambling" within that definition.

The position becomes more interesting when considering betting. The Gambling Act expressly refers to "betting" in several sections, including within the definition of "unlawful gaming". However, unlike "gambling", the expression "betting" is not itself defined. "Unlawful gaming" includes the act of betting or playing a game for a stake where carried on in certain specified locations, including a public place, licensed premises or a common gaming house.

Sections 9 and 10 of the Gambling Act similarly contemplate persons "gambling or betting" in particular places. The legislation therefore appears to recognise betting as something distinct from the defined concept of gambling, but does not provide a comprehensive statutory definition of what constitutes a "bet".

That distinction is potentially important for prediction markets. A contract under which a participant stakes money on whether a football team will win a match or a particular candidate will win an election might readily be described as a bet in ordinary language. However, the Gambling Act does not contain the more detailed statutory framework found in modern gambling legislation identifying particular categories of betting or expressly dealing with online betting platforms.

A further question is whether a prediction market could constitute a "lottery". The Gambling Act defines a lottery as any "*game, method or device whereby money or money's worth is distributed or allotted in any manner depending upon, or to be determined by chance or lot*".

At first sight, a prediction market might appear to have some of those characteristics: participants acquire positions and money (or money's worth) is ultimately distributed according to an uncertain outcome. However, an important

distinction is that the outcome of a conventional prediction market is ordinarily determined by the occurrence or non-occurrence of an external event, rather than by chance or lot generated as part of the arrangement itself.

An election result, interest-rate decision, sporting event or corporate transaction is uncertain from the participant's perspective, but it would be highly irregular for them to be *determined by chance*. The same distinction can be illustrated by comparing a prediction market concerning which number will be randomly drawn in a lottery with one concerning whether a central bank will reduce interest rates. The former is inherently determined by chance; the latter is determined by the decision of an external decision-maker by looking at economic and financial data and considering what interest-rate environment is most likely to produce the desired inflation and employment/economic conditions in the future.

Whether a particular prediction market constitutes a lottery for the purposes of the Gambling Act will therefore depend upon its mechanics and the nature of the event determining the outcome. While some prediction markets could certainly be structured as a lottery, many are not as uncertainty as to an outcome or decision, should be conflated with those things occurring 'by chance'. It would, therefore, be difficult to conclude that uncertainty of outcome means the underlying arrangement automatically constitutes a lottery.

The distinction matters because the Gambling Act contains extensive prohibitions relating to public lotteries. Among other things, it prohibits certain persons from assisting in carrying on a public lottery and from receiving money or money's worth in respect of a chance, event or contingency connected with one.

An old statutory regime applied to new technology

The Gambling Act clearly contemplates gambling, betting and lotteries, but much of its operative machinery is constructed around physical places, common gaming houses and conventional lotteries that have been around for decades.

For example, a "common gaming house" is defined by reference to a "place" kept or used for gambling or a public lottery, while the definition of "place" itself refers to houses, offices, rooms, buildings, ships, boats, vessels and vehicles.

Sections 19 to 22 of the Gambling Act contain further detailed provisions dealing with premises at which money is received in return for agreements to make payments upon specified events or contingencies, but those provisions are themselves framed by reference to lotteries, raffles and games or pretended games of chance.

Applying provisions drafted in those terms to a decentralised online prediction market is consequently not always intuitive. The analysis should not begin and end with the commercial observation that participants are effectively "betting" on an outcome. It requires consideration of the particular statutory prohibition relied upon and whether the activities and persons involved actually fall within it.

SIBA

Irrespective of the position under the Gambling Act, SIBA requires separate consideration.

A person carries on securities investment business for the purposes of SIBA where that person engages, in the course of business, in one or more of the activities specified in Schedule 2 of SIBA and is, among other things, a Cayman company or other specified Cayman entity, or has established a place of business in Cayman through which those activities are conducted.

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

SIBA contains specified categories of securities rather than simply regulating anything acquired with an expectation

of financial return. Options, futures and contracts for differences ("**CFDs**") are among the categories 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 security, currency or precious metal 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.

Schedule 1 of SIBA includes rights under a CFD or any other contract whose purpose or pretended purpose is to secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or in "*an index or **other factor** designated for that purpose in that contract*" (emphasis added).

The reference to an "other factor" is potentially significant for prediction markets because it suggests that the contract does not necessarily need to derive its value from a conventional financial asset or index. For example, in a prediction market concerning whether a particular candidate will win an election, the election result could arguably constitute the "other factor" by reference to which the participant makes a profit or suffers a loss. That said, the statutory language refers specifically to "fluctuations" in the relevant factor, and it is less clear whether a binary event which simply occurs or does not occur can properly be described as fluctuating.

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

This does **not** mean that every prediction market contract will necessarily constitute a CFD under SIBA. The statutory language refers to "fluctuations" in the relevant factor and its application to a purely binary event which simply occurs or does not occur is not beyond doubt. The statutory definition must therefore be applied to the precise legal and economic characteristics of the relevant contract. That said, this may result in more granular arguments. For example, is the outcome of a sporting event binary or does it fluctuate? Does one simply look at the final score in football match or does the outcome "fluctuate" for SIBA purposes, if the winning team was a goal down at half time?

It does, however, mean that the SIBA analysis should not be confined to prediction markets concerning traditional financial products only. The fact that the underlying event is political, sporting or otherwise unrelated to conventional securities does not, by itself, determine whether the resulting contract is a security.

Operating the Platform

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

Schedule 2 of SIBA identifies a number of regulated activities, including dealing in securities, arranging deals in securities, managing securities and advising on securities. In particular, "arranging deals in securities" includes making arrangements with a view to another person buying, selling, subscribing for or underwriting securities.

A prediction market operator would need to consider whether the functions it performs fall within one or more of the specified regulated activities, with arranging deals in securities likely to require particular attention.

There are also relevant exclusions. For example, Schedule 3 of SIBA excludes certain arrangements whose purpose is merely to enable parties to a transaction or potential transaction to communicate with one another. Whether that exclusion is available to a prediction market platform will depend upon what the platform actually does. A platform which merely provides a forum through which participants identify and communicate with one another

presents a materially different case from one which creates the contracts, matches transactions, controls liquidity or otherwise participates in their execution. Importantly, describing a platform as "decentralised" does not determine its regulatory treatment. The analysis remains focused on the persons involved and the functions they actually perform.

Virtual assets

The use of blockchain technology introduces a further layer to the analysis.

Amendments to SIBA introduced in 2020 expressly brought certain virtual assets within its remit. In particular, Schedule 1 of SIBA was amended to include virtual assets which can be sold, traded or exchanged immediately or in the future and which either represent or can be converted into an existing category of security or represent a derivative of one.

The amendments also introduced the concept of a "virtual asset trading platform", expressly contemplating both centralised and decentralised digital platforms which facilitate the exchange of virtual assets for fiat currency or other virtual assets on behalf of third parties for a fee or other benefit and which satisfy specified custody or transaction-matching criteria. Importantly, the definition excludes a platform which merely provides a forum on which buyers and sellers post bids and offers where the parties then trade separately or peer-to-peer.

Accordingly, a blockchain-based prediction market cannot be analysed under SIBA without also considering the nature of the digital assets used and the functions performed by the platform under the Virtual Asset (Service Providers) Act of the Cayman Islands (the "**VASP Act**").

One platform but different regulatory outcomes

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

A market whose outcome is determined by a random draw may raise obvious issues under the Gambling Act's provisions concerning lotteries. A market concerning an election, sporting result or central-bank decision presents a more difficult gambling analysis because the relevant outcome is external to the arrangement and the Gambling Act does not comprehensively define or regulate betting as a standalone activity.

At the same time, the breadth of the CFD provisions under SIBA means that an event contract may potentially constitute a security 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 that outcome is determined by chance or by an external event;
- the legal and economic characteristics of the contract or token acquired by the participant;
- whether the contract falls within one of the categories of securities 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 Cayman 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.

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.

That does not mean that there is a regulatory vacuum. The Gambling Act, SIBA and the VASP Act provide existing frameworks through which the activities can be analysed. However, none regulates 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 Cayman 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 Cayman law.

This publication is not intended to be a substitute for specific legal advice or a legal opinion. For specific legal advice on the subject matter of this Briefing, please contact:

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