Regulating Prediction Markets in Europe Requires a 'Prediction Test'

'Prediction markets' is an emerging term referring to a business model involving an online platform that enables users to enter and trade event-based contracts. Recent commercial success by certain operators in the United States has brought mainstream attention and triggered legal scrutiny as regulators confront the model's novelties.

In Europe, several countries have imposed bans on well-known operators, doing so through national gambling legislation. These include Belgium, Cyprus, France, Germany, Greece, Netherlands, Poland, Portugal, Romania, Switzerland and Ukraine. Great Britain's Gambling Commission stated it does not believe that prediction markets would be able to classify themselves as non-gambling products.

The Business Model

The model's core common feature is that users can buy and sell contracts, which depend on the outcome of an uncertain event, presented as a binary outcome: a 'yes' or 'no' to its occurrence being the sole determining factor.

As noted by the Autorité Nationale des Jeux, the price of contracts results from the interaction of participants' positions and can be interpreted as a collective aggregate probability of the event occurring.

The expectation of a user's pecuniary gain may thus arise:

1. By retaining the contract until occurrence of the event. Contracts are typically structured to return a fixed sum if the outcome materialises, and nothing if not.
2. Through secondary market trading, by selling the contract before the outcome occurs at a higher price than purchased, thereby realising gain through price fluctuations.

From the operator's perspective, no commercial risk regarding the outcome of the event is assumed. Instead, operators function as intermediaries by facilitating trading between users, without taking risk positions themselves. Their pecuniary gain is derived from transaction fees, commissions, or other platform-based charges.

Regulation and Binary Contingency

Binary contingency based on an uncertain future event is an accepted longstanding feature of European legal systems and permeates existing business models. For example, gambling, insurance, and financial instruments all rely on contracts involving risk allocation where financial outcomes depend on future uncertain events.

The novelty of prediction markets instead lies in the breadth of underlying events that may be offered. These range from conventional events such as the outcome of a football match or whether share price will exceed a specified level, to significantly unconventional or controversial events such as those related to politics, religion or war predictions.

Conceptually, any uncertain event may become a prediction contract provided that its outcome can be verified. This conceptually unlimited diversity complicates regulatory classification.

To date, European regulatory responses have largely relied on national gambling frameworks. However, financial services legislation may also be relevant, particularly the Markets in Financial Instruments Directive ('MiFID II').

MiFID II regulates financial markets including investment services and financial instruments, key of which in this context are 'derivatives'. MiFID II does not provide any exhaustive definition thereof and instead, under Annex I, Section C, it enumerates options, futures, swaps, forwards, contracts for differences, credit derivatives and certain commodity and emission allowance contracts as being derivatives.

MiFID II ultimately took the form of a directive, not a regulation that is directly applicable in a harmonised manner across Member States, thereby rendering the difficulty more pronounced. Furthermore, the European Securities and Markets Authority ('ESMA') had issued temporary restrictions within the EU as regards a derivative which ESMA had defined as a 'binary option', namely 'any cash settled derivative in which the payment of a fixed monetary amount depends on whether one or more specified events in relation to the price, level or value of the underlying occurs at, or prior to, the derivative's expiry'.

Given the lack of harmonised terminology, interpretation of binary options in Europe tends to derive from how such instruments fall as derivatives under MiFID II, and how past regulatory decisions, particularly ESMA's, addressed them

for purposes of retail investor protection. Notably, ESMA has [expressed](#) that a common type of binary option is when one receives a fixed pay-out if the price of the underlying, such as an exchange rate, a share or a commodity, reaches a specified level. ESMA noted binary options are sometimes known as ['binary bets'](#) as they are highly speculative and the pay-out is quoted similarly to fixed-odds betting.

ESMA's restrictions were [not renewed](#) on the basis that many Member States had adopted restrictions which are permanently embedded within national frameworks and at least as stringent as ESMA's measures.

Given these restrictions exist within national frameworks and MiFID II does not provide a definitive classification of derivatives, prediction market operators face regulatory classification uncertainty across Europe. This is compounded by non-harmonised gambling laws and differing national interpretations of what constitutes gambling and how such activities may be regulated.

Regulatory Classification and the Proposed 'Prediction Test'

Determining appropriate legal classification requires assessing both the operator's activities and the characteristics of each specific contract offered given the conceptually endless possibilities.

Some prediction contracts may undeniably resemble MiFID II derivatives, including in some cases binary options. If it is concluded that a contract is a binary option, then it is likely that the activity is not permissible given that most Member States have national legislation prohibiting such activity for retail investors.

If another form of derivatives applies, then MiFID II regulation and authorisation for [multilateral system](#) activity would be applicable given the trading activities involved. Gambling law is the only other appropriate framework if a contract falls outside of MiFID II.

At the same time, it would be likely that most European nations would have public policy and national laws grounded in domains such as morality, religion, human dignity, security, and democratic processes which may render certain predictions inherently not permissible under any framework.

However, the endless possible diversity of events suggests that it is probable that gambling frameworks are the adequate framework for regulating most predictions conceptually. Some contracts being made available, such as

predicting a sports team's win, are effectively identical to sportsbook bets. Indeed, the user-to-user exchange of risk characteristic of prediction markets is not unprecedented within gambling. Peer-to-peer betting exchanges and certain trading-style betting formats have existed for many years.

The model could nevertheless be conceptually captured by both a multilateral facility license under MiFID II and separately under national gambling licensing frameworks, or simply be impermissible, in each case, depending on the classification of the specific underlying contracts.

This ambiguity suggests that structured regulatory guidance would be helpful if the model were to be authorised by a European regulator. Such guidance should not attempt to exhaustively define the permissible scope of predictions or what may amount to 'games of chance'. Doing so would likely prove counterproductive and guidance on the interpretation of derivatives (including binary options) and events that are not permissible would seem preferable instead.

A useful precedent can be drawn for such classification challenges by reference to the 'Financial Instrument Test' that was issued in Malta, back when it was the first European jurisdiction to introduce a comprehensive legal framework for crypto-assets in 2018. At time of promulgation of the Virtual Financial Assets Act, one of the principal challenges lay in regulating the issuance of crypto-assets and related services without exhaustively defining what could constitute such assets. The solution was a structured assessment framework enabling classification by exclusion: if an asset did not fall within already regulated categories, and was not otherwise an unregulated category, it would be classified as a 'virtual financial asset'—without rigidly defining what that concept was beyond in basic abstract terms. To a significant extent, similar classificatory logic has been replicated under the Markets in Crypto-Assets Regulation.

A comparable methodology could be applied to prediction markets. A 'Prediction Test' could provide a structured guidance process through categorisation and exclusion, by guiding whether a contract:

1. Falls within scope of MiFID II as a derivative, thereby those activities would be licensable under such framework; or
2. Should be considered prohibited as it constitutes binary options or prohibited on basis of public policy concerns and other legal restrictions; or

3. By exclusion, may be permissible and regulated in terms of national gambling frameworks.

Given the conceptually unlimited possible events, such a Prediction Test would guide regulatory classification through boundary-setting rather than defining the elusive 'games of chance'.

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