Securities Regulation in a Virtual World

Shannon L. Thompson*

I. INTRODUCTION........................................... 90
II. VIRTUAL WORLDS ....................................... 90
   A. What Is a Virtual World? ............................ 90
   B. The Virtual World of Second Life ................. 92
      1. The Economy of Second Life ..................... 93
      2. The "Securities" Markets of Second Life ....... 94
III. DO REAL WORLD SECURITIES LAWS APPLY TO VIRTUAL
      WORLD "SECURITIES"? ................................. 98
   B. Does Virtual Stock Qualify as a Security Under the
      Investment Contract Rubric? ......................... 101
      1. The Howey Test for Investment Contracts ...... 101
      2. Applying the Howey Test to Virtual Stock .... 103
         i. Investment of Money ......................... 103
         ii. Common Enterprise ......................... 103
         iii. Expectation of Profits Derived Solely From
              the Efforts of Others .................... 104
   C. Just a Game or a Real Investment? ............... 105
      1. SEC v. SG Ltd. ................................ 105
      2. Gambling or Investing? ......................... 108
IV. SHOULD THE SEC REGULATE VIRTUAL WORLD
    SECURITIES? ........................................... 110
   A. Real World Registration Costs Outweigh the Benefits
      of Virtual Offerings ............................... 111
   B. Regulation Will Stifle Valuable Research
      Opportunities ....................................... 112
   C. Self-Regulation May Be Sufficient ............... 114

* B.A., B.S., University of Florida, 2001, J.D., Florida State University College of Law,
expected 2009. The Author thanks Professor Barbara Banoff for her valuable comments on
an earlier draft of this Article. The Author also thanks Craig Schlottmann and Christa
Pletcher.
I. INTRODUCTION

The introduction of stock exchanges into virtual worlds like Second Life raises a multitude of issues for its users and real-world financial regulators like the Securities and Exchange Commission. Part II of this Article describes the recent phenomenon of virtual worlds. Part III of this Article argues that the financial instruments traded on virtual stock exchanges are securities for the purpose of securities laws, and that under the federal securities laws, virtual world securities should be subject to registration requirements and anti-fraud liability. Part IV considers the benefits of an SEC exemption for virtual world securities. The cost of compliance with the federal securities laws would likely cause the virtual exchanges to cease to exist, potentially resulting in a loss of valuable research opportunities. An improved self-regulation scheme will ensure that virtual world investors are better informed and protected against fraud.

II. VIRTUAL WORLDS

A. What Is a Virtual World?

In the last decade, technological advances in video gaming and virtual spaces have changed the lives of individuals worldwide. 1 Millions of individuals participate in "virtual worlds," which are computer-based interactive environments that simulate real life. 3 The broad term "vir-


2 The virtual world of Second Life reports that it has over thirteen million total residents, which includes the total number of registrations. Second Life, Economic Statistics, http://secondlife.com/whatis/economy_stats.php (last visited May 1, 2008). Commentators often argue that the numbers reported by virtual worlds do not accurately represent their current population. See, e.g., Robert Bloomfield, Metaverse Market Index, what it is and what it isn't, METAVERSE, Oct. 6, 2007, http://metaversed.com/robert-bloomfield/blog ("Everyone knows that Second Life doesn't have 9 million residents. Accountants would say that number is not a faithful representation of what people actually care about: how many people use the platform regularly, and how engaged are they when they are using it.").

tual world" includes community and commerce-focused worlds like Second Life. These types of virtual worlds share the following characteristics: (1) a shared space, allowing multi-user access; (2) a 3-D graphical user interface that depicts the world visually; (3) immediate and simultaneous interactions; (4) a lack of pre-programmed goals; (5) interactivity, allowing users to change or create customized content; (6) persistence, allowing the world to continue to exist and evolve whether or not the user is logged in; (7) social interaction, allowing in-world social groups such as clubs or neighborhoods; and (8) the use of an "avatar." An "avatar," a graphical representation of the user, may look like a human, animal, mythical creature, or any other representation the software allows. Some users create avatars that resemble their


4 See Christian Renaud, Into the Lion's Den..., Sept. 27, 2007, http://www.christianrenaud.com/weblog/2007/09/into-the-lions-.html ("The 'Virtual World' moniker runs the gamut from children's educational sites like Mokitown/Mobilekids through game-narrative-driven sites like World of Warcraft, and from web-based marketing vehicles like Coke Studios/MyCoke through to proprietary walled-garden worlds like Second Life and There.com. You may as well have called them 'Web 2.0' for all the ground the VW term covers.").

5 While some commentators use "pre-programmed goals," see, e.g., Bloomfield, supra note 3, at 17, others use the term "pre-scripted," see, e.g., Farnaz Alemi, An Avatar's Day in Court: A Proposal for Obtaining Relief and Resolving Disputes in Virtual World Games, 2007 UCLA J.L. & TECH. 6, 21 (2007).

6 See Castronova, supra note 3 at 6 ("[T]he program continues to run whether anyone is using it or not; it remembers the location of people and things, as well as the ownership of objects."); F. Gregory Lastowka & Dan Hunter, The Laws of the Virtual Worlds, 92 CAL. L. REV. 1, 6 (2004) ("While you sleep in real life, other people's [avatars] may be eating and dancing in your [virtual world] home... [V]irtual weddings will take place while you chat at the physical water cooler; and new social structures will emerge while you have dinner.").


8 Merriam-Webster Online, http://www.merriamwebster.com/dictionary/avatar (last visited Mar. 10, 2008) (defining an avatar as "an electronic image that represents and is manipulated by a computer user (as in a computer game)"). For the purposes of this Article, the term "user" refers to the human who accesses the virtual world through the online interface, and the term "avatar" refers to the graphical representation of the user. The term "resident" is specific to users of the virtual world Second Life. Second Life, Economic Statistics, http://secondlife.com/whatis/economy_stats.php (last visited Apr. 4, 2008) ("A Resident is a uniquely named avatar with the right to log into the Second Life world, trade Linden™ dollars and visit the Community pages.").

9 Virtual worlds allow you to chose a stock avatar upon registering and change its appearance at any time afterwards. See, e.g., Second Life, Create an Avatar, http://secondlife.com/whatis/avatar.php (last visited Mar. 10, 2008) ("Second Life is about personal expression and your avatar is the most personal expression of all. After all, an avatar is your persona in the
real world appearance, profession, personality, or name, while others take the opportunity to develop a character entirely distinct from their real life.  

B. The Virtual World of Second Life

The virtual world of Second Life is "a vast digital continent," filled with people, entertainment, opportunities, and experiences. Described as "an animated version of real life," users of Second Life interact with each other by maneuvering their avatars throughout in-world venues such as restaurants, churches, homes, movie theaters, and shops. Users engage in a wide-range of virtual activities, such as shopping, partying in nightclubs, attending art shows, religious worship, education, sex, charity fundraising, and market research.

Second Life was developed by the California-based corporation Linden Lab. Linden Lab acts like a landlord, renting out plots of virtual land in Second Life so that residents may build and control access to their virtual attractions. Second Life's 3-D world is created entirely by its residents, who use Linden Lab's building tools to make digital creations, such as restaurants, virtual clothing, cars, and storefronts. Second Life "residents" use Linden's programming language, LSL, to

---

virtual world. The picture below shows how easy it is to create your avatar. Despite offering almost infinite possibilities, the tool to personalize your avatar is very simple to use and allows you to change anything you like, from the tip of your nose to the tint of your skin. Don't worry if it's not perfect at first, you can change your look at any time."; see also Bloomfield, supra note 3, at 10 (describing how others in Second Life had helped a user change his avatar's appearance by giving him "clothes and hair to replace [his] newbie attire").


12 Annalee Newitz, Your Second Life is Ready, POPULAR SCI., Sept. 2006, at 76.


17 What is Second Life?, supra note 11.
bring their digital creations to life.\textsuperscript{18} Users are essentially permitted to act or perform however they choose through their avatars so long as these actions comply with the SL user guidelines.\textsuperscript{19} Linden Lab’s unique business model has attracted a flourishing community of entrepreneurs to Second Life.\textsuperscript{20} While Linden Lab profits by leasing virtual land, charging virtual property owners a monthly maintenance fee, and charging a commission for currency exchange, residents can also profit from selling their virtual goods and services.\textsuperscript{21} Dubbed as “the first ‘entrepreneurial virtual world,’” Second Life’s economy has even allowed one resident, a virtual real estate mogul, to make over $1 million U.S. dollars.\textsuperscript{22}

1. The Economy of Second Life

Virtual consumption of luxury cars, clothing, and other goods plays a major role in Second Life.\textsuperscript{24} Second Life encourages virtual consumption by promoting innovation and entrepreneurship, by protecting users’ creations with IP rights,\textsuperscript{25} and by rewarding users’ successes with real money.\textsuperscript{26} Residents have in-world careers such as wedding planner, tattoo artist, clothing designer, resort owner, detective, and virtual fur-

\textsuperscript{18} \textit{The First Entrepreneurial World}, supra note 16.


\textsuperscript{20} \textit{The First Entrepreneurial World}, supra note 16. While the first users of new technology are typically young male Americans, Second Life’s residents are “nearly evenly divided between men and women, have a median age in the 30’s, and most live outside of the United States.” Cory Ondrejka, \textit{Collapsing Geography: Second Life, Innovation, and the Future of National Power}, 2 \textit{Innovations: Technology, Governance, Globalization} 27, 32 (2007).


\textsuperscript{22} \textit{The First Entrepreneurial World}, supra note 16.


\textsuperscript{24} Lin, supra note 21, at 82.

\textsuperscript{25} Second Life, IP Rights, http://secondlife.com/whatis/ip_rights.php (last visited Feb. 27, 2008); \textit{see also} Second Life, What is Second Life?, http://secondlife.com/whatis/ (last visited Feb. 27, 2008) (“You’ll also be surrounded by the Creations of your fellow Residents. Because Residents retain intellectual property rights in their digital creations, they can buy, sell and trade with other Residents.”).

niture store owner. While it is free to join Second Life, it generally costs money to participate in virtual transactions.

Users can buy and sell their virtual products and services in Second Life with Second Life’s virtual currency, the Linden. The Linden is “[a]n internal unit-of-trade with real market value,” which may be bought or sold with real world currency on LindeX, Second Life’s official currency exchange, or through other third party exchanges in Second Life. The Linden facilitates commerce in Second Life’s virtual world economy. Residents who earn virtual money in Second Life can exchange their virtual currency for legitimate currency. Estimates of real-money trade (RMT) of virtual goods and services range from $5 to $901 million USD.

2. The “Securities” Markets of Second Life

Some Second Life entrepreneurs have taken virtual consumption so far as to build stock exchanges, which often imitate many of the

---

28 Lin, supra note 21, at 82; see also Second Life, What is Second Life?, http://secondlife.com/whatis/ (last visited Feb. 27, 2008) (“The Marketplace currently supports millions of US dollars in monthly transactions. This commerce is handled with the inworld unit of trade, the LindenTM dollar, which can be converted to US dollars at several thriving online Linden dollar exchanges.”).
30 Id.
31 What is Second Life?, supra note 11 (“The Marketplace currently supports millions of US dollars in monthly transactions. This commerce is handled with the inworld unit of trade, the LindenTM dollar, which can be converted to US dollars at several thriving online Linden dollar exchanges.”).
32 The First Entrepreneurial World, supra note 16.
34 Tuukka Lehtiniemi, How Big Is the RMT Market Anyway?, Virtual Economy Research Network, Feb. 3, 2007, http://virtual-economy.org/blog/how_big_is_the_rmt_market_anyway. It is difficult to determine what certain RMT estimates include. Id. Estimates often exclude trades that could be considered RMT. Id. For instance, user-to-user trades are usually taken into account while sales by virtual world operators are not. Id.
characteristics of a real world stock exchange.\textsuperscript{35} The exchanges are located in colossal virtual buildings, and avatars dressed as security guards roam the shiny marble-floors of the high-ceilinged lobbies.\textsuperscript{36} Virtual exchanges give virtual business owners the ability to raise capital by selling shares in their virtual companies.\textsuperscript{37} The virtual companies are business operations controlled by avatars and residents in the virtual world and do not exist as real world corporations.\textsuperscript{38} Other users can buy and sell shares of stock in these virtual world companies with virtual world currency, which can be exchanged for real world currency.\textsuperscript{39} Stock exchanges currently operating in Second Life include\textsuperscript{40} the SL Capital Exchange (SLCAPEX)\textsuperscript{41}, the World Stock Exchange (WSE),\textsuperscript{42} the Virtual Stock Exchange (VSTEX),\textsuperscript{43} and the International Stock Exchange (ISE).\textsuperscript{44}

Companies listed on one of Second Life’s virtual stock exchanges provide investors with documentation, which is often a pared down model of real world documentation.\textsuperscript{45} Issuers provide investors with a so-called “prospectus” that includes information such as “risk factors.”\textsuperscript{46} The risk factors that the listed companies identify tend to cover one or more of three categories: (1) general risks of Second Life, (2) risks specific to listed companies on virtual exchanges, and (3) risks specific to a particular issuer.\textsuperscript{47} Risks stemming from the general nature

\textsuperscript{35} \textsc{Benjamin Tyson Duranske, Virtual Law: Navigating the Legal Landscape of Virtual Worlds} 218 (2008).
\textsuperscript{36} \textit{Id.}
\textsuperscript{37} World Stock Exchange, http://www.wselive.com/ (last visited Apr. 11, 2008) ("The WSE enables listed companies to raise capital and gain brand awareness by participating in the game while providing . . . investors with an opportunity to learn, have fun, trade securities and earn interest in a simulated gaming environment using the World Internet Currency with a license that can be purchased and sold for real US Dollars.").
\textsuperscript{39} \textit{See supra} note 37.
\textsuperscript{40} \textit{See Duranske, supra} note 35, at 218 (“There are at least two or three stock exchanges operating in Second Life, which occasionally buy each other, merge, split, and are renamed.”).
\textsuperscript{42} \textit{See World Stock Exchange, supra} note 37.
\textsuperscript{43} Virtual Stock Exchange, VSTEX, http://www.vstex.net/ (last visited Apr. 11, 2008).
\textsuperscript{47} \textit{See infra} notes 48-54 and accompanying text (providing examples of such risk factors).
of Second Life include a collapse of Linden Lab,\(^4^8\) server downtime,\(^4^9\) and a lack of predictability as to the future popularity of Second Life.\(^5^0\) Risks for all listed companies include a collapse of the virtual stock markets,\(^5^1\) competition,\(^5^2\) and the market's rejection of a brand.\(^5^3\) Risks specific to particular issuers include the risk that Linden Lab will implement an age verification system.\(^5^4\)

Virtual world issuers often include measures to protect against the risk factors specified in their prospectuses.\(^5^5\) For instance, a virtual sex business states that if Linden Lab implements an age verification system, it will change its policy by prohibiting explicit images.\(^5^6\) Similarly, a virtual retail company may protect against the risk of static sales by hiring a marketing firm to aid in branding.\(^5^7\) A virtual media and entertainment company retained a Second Life law firm to protect itself in real world and Second Life matters.\(^5^8\) While some issuers include thoughtful descriptions of risk factors in their prospectus, others include unrealistic and vague claims regarding risk. One issuer downplays

\(^{48}\) POW Prospectus, supra note 46.


\(^{51}\) POW Prospectus, supra note 46.

\(^{52}\) SL Marketing Prospectus, supra note 49.


\(^{54}\) SL Capital Exchange, XXX: Tropical Temptations, http://www.slcapex.com/symbol/XXX/profile (last visited Apr. 4, 2008) [hereinafter Tropical Temptations] (describing the potential risk that its virtual sex business would have to comply with an age verification system).

\(^{55}\) See, e.g., Vlada Fine Furniture & Fixtures, supra note 53 (noting the risk of brand failure and static sales and describing its precaution of hiring “one of the top branding SL pros for SL businesses wanting to make an impact in their respective markets.”).

\(^{56}\) Tropical Temptations, supra note 54 (noting that the company “will simply ask all advertisers and escorts to change their pictures to non-explicit images. We are a resort with rooms for rent, and although we cater to sex trade workers, as long as there are not explicit images . . . we don’t need to . . . prevent access.”).

\(^{57}\) Vlada Fine Furniture & Fixtures, supra note 53.

the significance of risk factors by claiming that its "business model and resourceful staff can minimize or virtually eliminate the impact from these variables."59

In addition to providing a "prospectus," issuers may also be required by the virtual exchange on which they are listed to regularly report financial information and make certain disclosures.60 But, while the exchanges have implemented stricter requirements, listed companies do not provide detailed financial statements that may be audited by third parties.61 Listed companies generally do not have real world professional CFO or CPA personnel.62 The issuer is not always required to provide the real world name and location of the CEO,63 and many listed companies do not indicate a dividend policy.64 While many of the virtual stock exchanges have listing rules, these requirements are often unlike those of real world exchanges.65 For instance, the World Stock Exchange requires an "advanced knowledge of the English lan-

59 Logo Coding Prospectus, supra note 50.

60 Samantha Goldflame, Vstex, Reports Collection, Apr. 11, 2008, http://www.vstex.net/?p=103&id=114 (reporting that “[f]or the first time on our exchange, listed companies are required to post a mandatory single-step income statement for Q1, 2008" but noting that “[c]ompanies and reports have not been audited or verified.”); see also Vstex, Income Statements and Reports Collection, http://docs.google.com/View?docid=ddxwdjgk_2mxfp3scf (last visited Apr. 11, 2008) (listing the required income statements of companies listed on Vstex).


63 See World Stock Exchange, Action Mortgage & Investment (AMI), Prospectus, http://www.wselive.com/research/prospectus/12 (last visited Apr. 12, 2008) (indicating that the CEO’s real life name and location are not specified and noting that “[r]eal life details are optional as the WSE is a fictional securities exchange based on real and virtual businesses.”). But see International Stock Exchange, List Your Company, http://www.intlstockexchange.com/ownerCompanyProfile.php (last visited Apr. 12, 2008) (requiring the CEO’s real life name and location in the listing application).

64 Swan, supra note 61; see also Vlada Fine Furniture & Fixtures, supra note 53 (failing to provide a dividend policy). But see International Stock Exchange, Jamaica Estates, http://www.intlstockexchange.com/CompanyProfile.php?id=28 (last visited Apr. 10, 2008) [hereinafter Jamaica Estates] (indicating its dividend policy is “to pay a 2.5c dividend per month, that will be paid bi-monthly starting 15th April.”).

65 Bradley, supra note 45 at 21.
guage." The Virtual Stock Exchange requires business models be based on the virtual world, dealing in virtual products.

Another key difference between real world and virtual world investing activities is that virtual stock exchanges and issuers do not comply with federal securities laws. Neither the U.S. Securities and Exchange Commission nor a foreign equivalent currently regulates investing activities in virtual worlds. While there are self-regulatory bodies in Second Life, such as the Second Life Exchange Commission, these groups do not have any legal authority. Commentators have predicted that, in the very near future, the SEC or a foreign equivalent will find that the sale of virtual world stock for virtual currency is subject to regulation under existing securities laws. The next Part of this Article examines whether virtual world securities are, in fact, securities subject to regulation under the federal securities laws.

III. DO REAL WORLD SECURITIES LAWS APPLY TO VIRTUAL WORLD "SECURITIES"?

Federal securities laws are applicable only if a "security" is involved in a transaction. The definition of a security is expansive, in-

---

68 DURANSKE, supra note 35 at 247.
69 Id.
70 Swan, supra note 61.
71 See S. Gregory Boyd & Matthew E. Moersfelder, Global Business in the Metaverse: Money Laundering and Securities Fraud, ABA SCI TECH LAW, Winter 2007, at 7 ("The authors suggest that the issue[ ] of . . . securities fraud in virtual worlds will emerge in the coming years."); DURANSKE, supra note 35 at 218 ("[T]he introduction of real cash economies into games and social virtual worlds, the encouragement some virtual world providers give users to treat the worlds as economic playgrounds, and the pseudoanonymously nature of these spaces, all combine to create an almost unavoidable collision between securities regulation and virtual worlds. Given the boldness with which the virtual world 'markets' are managed and promoted, and the inevitable ethical lapses that accompany a complete lack of oversight, it is only a matter of time before the SEC takes action against a virtual world user for actions that violate U.S. securities regulations."); Posting of Benjamin Duranske, Virtually Blind's Predictions for Virtual Law in 2008, http://virtuallyblind.com/2008/01/01/2008-virtual-law-predictions/ (Jan. 1, 2008) (predicting that, in 2008, "[t]he SEC or a foreign securities enforcement group will declare the sale of shares of virtual world companies for virtual currency an act covered by securities laws.").
including both enumerated financial instruments, such as stocks and bonds, and general catchall terms, such as "investment contracts" and "evidence of indebtedness." In defining a "security," courts have struggled to determine when an enumerated financial instrument such as "stock" should not be included and whether and when atypical investments fall within the term "investment contract." The following sections will address these questions in the context of virtual world investments.

A. Is Virtual "Stock" Really Stock?

When a person sells a financial instrument termed "stock," he or she is presumed to be selling a "security," unless the instrument does not have the same characteristics as stock. Characteristics typically associated with stock include dividend rights, liquidity rights, proportional voting powers, and appreciation potential. Where the so-called security bears these typical characteristics, "a purchaser justifiably [may] assume that the federal securities laws apply." In United Housing Foundation, Inc. v. Forman, the Supreme Court first applied the "stock characteristics test" to determine when securities laws might apply, The Court held the financial instrument termed "stock," which entitled the purchaser to lease an apartment in a non-profit housing cooperative, was not stock subject to the federal securities laws. The so-called stock had none of the typical characteristics of a stock investment—Residents lacked proportional voting powers; the shares were non-negotiable and doubled as a refundable deposit; and departing residents were required to resell their shares to the corpora-

---

73 Bloomenthal, supra note 72, at § 2:1; see also Securities Act of 1933 § 77b (a)(1) ("The term 'security' means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.").

74 Bloomenthal, supra note 72, at § 2:1.
75 United Housing Found., Inc. v. Forman, 421 U.S. 837, 850 (1975).
76 Id. at 851.
77 Id. at 850.
78 Id. at 851.
79 Id.
tion at the original price.\textsuperscript{80} Without the typical characteristics of stock, the federal securities laws did not apply.\textsuperscript{81}

In contrast to the “stock” in \textit{Forman}, however, virtual stock bears characteristics typically associated with stock.\textsuperscript{82} One such characteristic is that stockholders’ right to receive dividends contingent upon an apportionment of profits.\textsuperscript{83} For instance, Tropical Temptations, a virtual resort and escort agency listed on the SL Capital Exchange, includes in its prospectus that, “[i]n terms of a return for shareholders, 100% of the profits of the company will be posted as a dividend.”\textsuperscript{84} Shareholders in the virtual world can also realize a profit when their shares appreciate in value.\textsuperscript{85} Shareholders have proportional voting rights\textsuperscript{86} and liquidity rights.\textsuperscript{87} Because “virtual stock” clearly bears the typical characteristics of stock, it is stock, and thus a security subject to the federal securities laws. But, while virtual stock seems to fall within the reach of federal securities laws under the stock characteristics test, a court may alterna-

\begin{itemize}
\item \textsuperscript{80} Id.
\item \textsuperscript{81} Id.
\item \textsuperscript{82} See Penny Crosman, \textit{Virtual Stock Exchange Opens in Second Life}, \textit{WALL STREET \& TECHNOLOGY}, Mar. 16, 2007, http://www.wallstreetandtech.com/blog/archives/2007/03/virtual_stock_e.html (quoting the CEO of the World Stock Exchange as stating that “[t]he World Stock Exchange is a stock market simulator in a virtual world that uses the same terminology that you find in real life and that provides education on how to buy and sell shares. You buy shares in a company and the shares can go up or down depending on market sentiment. So everything is simulated to replicate real life”).
\item \textsuperscript{83} See, e.g., SL Capital Exchange, DCTY: Dreamcities.net, Prospectus, http://www.sl-capex.com/symbol/DCTY/profile (last visited Apr. 6, 2008) (“15% of the returns would go back into the community for our expansion onto more sims and to provide more services to our residents. The rest of the returns will be dividends on a monthly basis to our shareholders.”).
\item \textsuperscript{84} Tropical Temptations, supra note 54.
\item \textsuperscript{85} See Crosman, supra note 82 (quoting the CEO of the World Stock Exchange as indicating “the shares can go up or down depending on market sentiment”); see also SL-Newspaper, Opinion, Oct. 29, 2007, http://sl-newspaper-bnc.blogspot.com/2007/10/weekly-business-review-29-oct-07.html (indicating that two particular virtual stock investments “both offer dividends and appreciation potential at reasonable risk”).
\item \textsuperscript{86} See World Stock Exchange, Constitution, Voting Rights, http://www.wselive.com/info/constitution (last visited Apr. 5, 2008) (“A Director may propose a resolution to all shareholders on behalf of one or more shareholders, every shareholder present in person or by proxy has one vote per share owned on a vote using WSE voting system.”); see also Press Release, VSTEX, SLC-CCI End of Talks, (Nov. 14, 2007, 05:28), http://your2ndplace.com/node/658#comment-5223 (describing a proposal that was submitted to shareholders for a vote).
\item \textsuperscript{87} See World Stock Exchange, Constitution, Liquidation Rights, http://www.wselive.com/info/constitution (last visited Apr. 5, 2008) (“Each ordinary Share ranks equally in the event of liquidation. The liquidation value is calculated as the Net Tangible Asset and is displayed on the company profile.”).
\end{itemize}
tively decide to analyze virtual stock under the investment contract rubric.\textsuperscript{88}

B. \textit{Does Virtual Stock Qualify as a Security Under the Investment Contract Rubric?}

The catchall term “investment contract” extends the reach of the securities laws to include non-obvious financial arrangements in which investors depend on others to manage the enterprise that will produce financial returns on their investment.\textsuperscript{89} While courts have liberally used the “investment contract” approach to include a wide assortment of obscure financial “investments,” courts have also refused to extend the laws to specifically defined securities where there is no perceived investment interest.\textsuperscript{90} Whether virtual stock is considered a security could therefore depend on whether it fits under the definition of an investment contract.\textsuperscript{91}

1. The \textit{Howey} Test for Investment Contracts

In \textit{SEC v. W.J. Howey Co.}, the Supreme Court provided the current test to determine whether a particular financial instrument is an “investment contract,” and thus, a “security.”\textsuperscript{92} Under the test, an investment contract is: (1) the investment of money; (2) in a common enterprise; (3) with the expectation of profits derived solely from the efforts of others.\textsuperscript{93} The test must be applied in light of the “economic realities” of the transaction, which means that the substance of the transaction governs its form.\textsuperscript{94} Thus, the securities laws cannot be avoided merely by calling a financial arrangement by a non-enumerated term.\textsuperscript{95}

\textsuperscript{88} The investment contract analysis normally applies only after the “stock” fails the stock characteristics test. \textsc{David A. Lipton}, 15 Broker-Dealer Reg. § 1:48 (2007).

\textsuperscript{89} \textsc{Bloomenthal}, \textit{supra} note 72, at § 2:1.

\textsuperscript{90} \textit{Id.} at § 2:1; \textit{see also} Forman, 421 U.S. at 851 (holding that shares in a non-profit cooperative housing corporation, despite the fact that the shares are “stock” under the stock characteristics test, are not a security since there is no potential for realizing either dividends or capital appreciation).

\textsuperscript{91} \textit{SEC v. W.J. Howey Co.}, 328 U.S. 293, 298-99 (1946) (providing the test for an investment contract).

\textsuperscript{92} \textit{Id.} at 298.

\textsuperscript{93} \textit{Id.} at 298-99.

\textsuperscript{94} \textsc{Forman}, 421 U.S. at 851-52.

\textsuperscript{95} \textit{W.J. Howey Co.}, 328 U.S. at 301 (“[T]he arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed. The investment contracts in this instance take the form of land sales contracts, warranty deeds and service contracts.”); \textit{see also} \textit{SEC v. SG Ltd.}, 265 F.3d 42, 46-48 (1st Cir. 2001) (“It is . . . immaterial whether the promoter depicts the enterprise as a serious commercial venture or dubs it a game.”).
In *Howey*, the Court held that the sale of an orange grove, in conjunction with a service contract, constituted an investment contract, and thus, a security. The SEC brought enforcement proceedings related to a scheme in which individuals purchased small tracts of land in a Florida citrus grove. While purchasers invested in the enterprise with an expectation of profit sharing, they generally lacked the knowledge, skill, and equipment necessary for the care and cultivation of citrus trees. The purchasers were encouraged to purchase their land in combination with a service contract that granted the service company full and complete possession of the tract. The Court held that such arrangements are investment contracts "regardless of the legal terminology in which such contracts are clothed." The Court noted that the investment contracts in *Howey* took the form of contracts for the sale of land, warranty deeds, and service contracts that were offered to prospective investors.

Courts have applied the *Howey* test in a wide range of contexts. The following schemes have been held to be investment contracts: the sale of earthworms where the seller promised to repurchase the earthworms and market them to farmers, chinchilla breeding with a resale agreement, and a pyramid scheme for selling cosmetics in which the seller conducted promotional meetings and the buyer received a commission for each new person brought into the scheme. In each instance, individuals had invested money with the expectation of profits to be derived predominantly from the efforts of the promoter. The inducement to invest money was not the ownership of the orange grove or chinchillas, but rather the profits derived from the marketing or management efforts of others.

---

96 W.J. Howey Co., 328 U.S. at 298.
97 Id. at 295.
98 Id. at 296.
99 Id.
100 Id. at 300.
101 Id.
102 BLOOMENTHAL, supra note 72, at § 2:1 ("Under certain circumstances, a franchise, an orange grove, a condominium, real estate lots, gold and silver bullion, diamonds, beavers, chinchillas, and minks have been held to constitute an investment contract, hence, a security.").
103 Smith v. Gross, 604 F.2d 639, 641 (9th Cir. 1979).
106 BLOOMENTHAL, supra note 72, at § 2:1.
107 Id.
2. Applying the Howey Test to Virtual Stock

i. Investment of Money

The first prong of the Howey test, an investment of money, is satisfied where an "investor cho[oses] to give up a specific consideration in return for a separable financial interest with the characteristics of a security." The investment does not have to take the form of cash, but rather may be "some tangible and definable consideration." Virtual world investments do not involve direct cash investments, but rather investments of virtual world currencies. Some commentators argue that virtual currency has value if it can be easily converted into real world cash. Regardless of its convertibility, virtual currency has value because users can trade it for virtual goods, services, or admission to events; it thus constitutes tangible consideration.

ii. Common Enterprise

A common enterprise exists where there is horizontal commonality, which is satisfied if investors retain interrelated interests in a common scheme. Horizontal commonality requires the pooling of the contributions of multiple investors and the distribution of profits and losses on a pro-rata basis among all of the investors. The common

---

108 Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559-60 (Brennan, J. concurring) (discussing whether a security was involved when employers made contributions into a noncontributory employees' retirement plan and noting that "an employee is selling his labor primarily to obtain a livelihood, not making an investment").
109 Id. at 560.
110 See SL Capital Exchange, CapEx Information, http://www.slcapex.com/content/info (last visited Apr. 15, 2008) ("The unit of measure commonly called Lindens ($L) is not legal tender in our view.").
111 See Bradley, supra note 45, at 26 (indicating that the investment of money prong may be problematic because virtual currencies may or may not be treated as equivalent to real world money); Duranske, supra note 35 at 221 (arguing that virtual world currency has value because it "can be readily converted to cash").
112 Ken Dreifach, Following the Law of the White Rabbit: Emerging Issues in Law, Ethics and Policy in Virtual Worlds, 929 PLI 579, 583; see also Daniel, 439 U.S. at 560 (indicating that an investment does not need to take the form of cash and could be goods or services).
113 Bloomenthal, supra note 72, at § 2:2. While all circuits accept horizontal commonality, some accept one of the two versions of "vertical commonality," which are easier to show. Id. Broad vertical commonality requires "the fortunes of investors be tied to the fortune of the promoter." Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994). Strict or narrow vertical commonality requires the investors' fortunes be "interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 n.7 (9th Cir. 1973); see also Bloomenthal, supra note 72, at § 2:2 (describing the split among courts on the commonality issue).
114 Id.
enterprise prong presents no obstacle with regard to the sale of securities in virtual world IPOs because issuers present the securities to prospective investors as having the kind of pooling and management characteristics as investments in real life IPOs. The investors' contributions are pooled and the profits and losses are distributed pro-rata among the investors.

iii. Expectation of Profits Derived Solely From the Efforts of Others

An expectation of profits may be satisfied by "capital appreciation resulting from the development of the initial investment" or "participation in earnings resulting from the use of investors' funds." Capital appreciation and earnings differ from transactions in which an individual is motivated to purchase a commodity for use or consumption. In the context of investing in shares of virtual world companies, the investments offer both dividends and appreciation potential. Some issuers make statements practically guaranteeing profit to virtual world investors. While the operators of the virtual world exchanges argue that users pay for an entertainment commodity, most virtual world investors see a real investment opportunity with profit potential. The requirement that profits come solely from the efforts of others is satisfied as

115 Bradley, supra note 45 at 26.
116 See, e.g., SL Capital Exchange, Status of Alleninvest-AIG Settlement (Nov. 11, 2007), http://www.slcapex.com/forums/topic/allen/878?page=11 (discussing the liquidation of a virtual company and announcing that "[c]laimants can anticipate the first pro rata distribution of the proceeds within the next few days").
118 Id. at 858.
120 See, e.g., SL Capital Exchange, YEP: Yellow Paperclip Corp, Prospectus, http://www.slcapex.com/symbol/YEP/profile (last visited Apr. 20, 2008) ("YEP! is a stock that is able to give you profit with very low risk.").
121 Second Life Financial Markets Panel a "Smashing" Success, supra note 10(describing a panel discussion held in Second Life, the moderator indicated that when he "noted the *possibility* that the markets could be 'viewed as a game,' the audience chat when off the charts, mostly in vehement disagreement. However, the exchange leaders clearly agreed with the view that the exchanges are a game."). All of the virtual stock exchanges have disclaimers indicating that the "game" is not an investment of money for profit. See, e.g., SL Capital Exchange, CapEx Information, http://www.slcapex.com/content/info (last visited Apr. 12, 2008) ("It is NOT a REAL WORLD SECURITIES ENTITY and does NOT offer ANY opportunity for REAL WORLD PROFITS or INVESTMENT.").
long as the efforts of others are significant managerial efforts.\textsuperscript{122} In satisfying this requirement, the prospectuses of the virtual companies describe business strategies and measures taken by management to ensure that investors will receive a profit.\textsuperscript{123}

C. Just a Game or a Real Investment?

Though investments in virtual companies include many of the same characteristics as those of real world securities, federal securities laws are intended to control financial investments and not games.\textsuperscript{124} Virtual world stock markets, however, emphasize that they are just a "game."\textsuperscript{125} An important question is whether the game context in which virtual securities exist—and their attendant label as such—precludes their categorization as investment contracts.\textsuperscript{126} Excluding all investments made in a game context from the definition of a security could result in an undesirable situation in which fraudsters are encouraged to avoid SEC enforcement action by marketing their investment schemes as games.

1. SEC v. SG Ltd.

In \textit{SEC v. SG Ltd.}, the First Circuit ruled that virtual shares of stock, which were offered as part of a game by a foreign entity operating a virtual stock exchange, did fall within the SEC’s authority and were subject to its regulation as investment contracts.\textsuperscript{127} The defendant, SG, ran the virtual stock exchange on its Stock Generation website and allowed its users to use real world currency to purchase and trade shares in the eleven listed virtual companies.\textsuperscript{128} The website displayed a disclaimer, alerting prospective users that they would be playing a game and not making an investment.\textsuperscript{129} SG arbitrarily set the stock price and promised users that they would be able to buy and sell any amount of

\textsuperscript{122} SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973); see also Bloomenthal, \textit{supra} note 72, at § 2:2 (describing the shift away from a literal interpretation of "solely").


\textsuperscript{124} Bradley, \textit{supra} note 45, at 25.

\textsuperscript{125} See Online Video: YouTube, Investing in a Game?, July 25, 2007, http://www.youtube.com/watch?v=IIAG06k9m7o (describing the issue regarding whether trading on the virtual exchanges is a game activity or a real investment).

\textsuperscript{126} Bradley, \textit{supra} note 45, at 21.

\textsuperscript{127} SEC v. SG Ltd., 265 F.3d 42, 55 (1st Cir. 2001).

\textsuperscript{128} \textit{Id.} at 44. The listed companies did not exist in the real world. \textit{Id.}

shares at the posted price.\textsuperscript{130} SG did not limit the amount an investor could invest.\textsuperscript{131}

SG, however, manipulated the virtual stock market, causing shares in all of the companies to decrease dramatically.\textsuperscript{132} SG prevented users from being able to withdraw any funds from the game.\textsuperscript{133} At least 800 U.S. investors had paid more than $7 million.\textsuperscript{134} After receiving complaints from users in twenty-seven states, the SEC filed a civil action against SG, alleging that SG's activities constituted fraud in violation of the registration and anti-fraud provisions of the federal securities laws.\textsuperscript{135} In its complaint, the SEC focused on the shares of the "privileged company," a virtual company listed on the exchange that SG had touted as a surefire investment and a game without risk.\textsuperscript{136}

In its defense, SG claimed that, because the shares were part of a game created for entertainment, they were not securities and, as such, did not implicate the federal securities laws.\textsuperscript{137} The SEC countered by arguing that substance should prevail over form, and the "game" label should not therefore bar the applicability of the federal securities laws.\textsuperscript{138} The district court granted SG's motion to dismiss for failure to state a claim, finding the scheme did not constitute an investment in securities because it clearly characterized the exchange as a game and lacked a business context.\textsuperscript{139} On appeal, the First Circuit only considered whether the facts alleged in the complaint were sufficient to merit a trial.\textsuperscript{140} It did not have the opportunity to decide the ultimate issue of whether the "game" defense would protect SG from the reaches of the securities laws.\textsuperscript{141}

In its opinion reversing the district court, the First Circuit found that the SEC's factual allegations were sufficient to allow for a trial to determine whether SG's scheme was susceptible to, and had violated, the federal securities laws.\textsuperscript{142} It rejected the district court's distinction between "commercial dealings," which are subject to the securities

\begin{flushleft}
\textsuperscript{130} \textit{SG Ltd.}, supra note 128, at 44.
\textsuperscript{131} Id.
\textsuperscript{132} Id. at 44-45.
\textsuperscript{133} Id. at 45.
\textsuperscript{134} Id.
\textsuperscript{135} Id.
\textsuperscript{136} Id. at 44. SG had noted that the shares could not fall more than five percent because they were insured by company funds. Id. at 44-45.
\textsuperscript{137} Id. at 44.
\textsuperscript{138} Id.
\textsuperscript{139} \textit{SG Ltd.}, supra note 130, at 130-31.
\textsuperscript{140} \textit{SG Ltd.}, supra note 128, at 46.
\textsuperscript{141} Id.
\textsuperscript{142} Id. at 55.
\end{flushleft}
laws, and "games," which are not. The First Circuit noted that, as long as the Howey test is satisfied, the instrument must be characterized as an investment contract.

Applying the test, the First Circuit held that the SEC's allegations, if proven, supported its claim that the opportunity to invest in the shares of the privileged company on SG's website constituted an invitation to enter into an investment contract. The court noted that SG's representations, which indicated that investors in the privileged company could expect a profit, supported the SEC's claim that the situation involved an investment of money. The alleged facts led to a finding of horizontal commonality, which the court found sufficient to satisfy the common enterprise requirement. Pooling was established by SG's representations on its website that it accumulated players' money into one account to settle transactions. Each investor was entitled to share in profits proportional to his or her investment. The court determined that SG's alleged promises of profit with no investor effort satisfied the requirement that there be an expectation of profits derived solely from the efforts of others. The court further found that this promise to investors, if proven, was sufficient despite SG's argument that users transacted for entertainment, and not investment, purposes.

In light of these considerations, the First Circuit reversed and remanded the case, but questions of whether the users of the website were paying for an investment or a game remained unanswered because the parties settled before trial. Though the First Circuit did not resolve the relationship between real life and online interaction, it was willing to look past posted disclaimers regarding the substance of the financial instruments and the parties' actions. The court's willingness

---

143 Id. at 48.
144 Id.
145 Id. at 55.
146 Id. at 49.
147 Id. at 50. This was the first time that the First Circuit had ruled on the debated commonality requirement. Todd M. Tippett, Note, Game When They Win; Investment When They Lose: SEC v. SG Ltd., 7 SMU SCI. & TECH. L. R. 313, 317 (2003).
148 SG Ltd., supra note 128, at 50.
149 Id. at 51.
150 Id. at 55.
151 Id. at 53.
152 Id. at 55.
154 Boyd & Moersfelder, supra note 71, at 7.
to choose substance over form increases the likelihood that real world laws will be applied to virtual worlds.\textsuperscript{155}

2. Gambling or Investing?

Linden Lab's recent ban of gambling in Second Life raises the question of whether trading on the virtual exchanges constitutes gambling.\textsuperscript{156} The recent anti-gambling policy prohibits wagering in Second Life games if the games "rely on chance or random number generation to determine a winner."\textsuperscript{157} The games must also give a payout in virtual world currency, real world currency, or anything of value.\textsuperscript{158} While Second Life's policy included wagering games such as poker and slot machines, it did not include the buying or selling of virtual securities on the exchanges.\textsuperscript{159}

The virtual world exchange operators assert that selling virtual securities in a game context is neither gambling nor investing.\textsuperscript{160} The CEO of the World Stock Exchange in Second Life has commented that trading on the virtual exchanges is akin to playing a slot machine.\textsuperscript{161} However, during the same interview, the CEO described the exchange and trading as replicating real life investment activities.\textsuperscript{162} Perhaps the virtual exchange operators are sending users mixed messages because of the similarity that both gambling and investing activities share – namely, that of risk-taking.\textsuperscript{163}

\textsuperscript{155} Id.; See also American Bar Association, Section of Science & Technology Law: Virtual Worlds and Multi-user Online Games, http://www.abanet.org/dch/committee.cfm?com=ST25 2000 (last visited May 2, 2008) (indicating that the "ongoing success and expansion of virtual worlds and MMO games increases the likelihood of both legislation and litigation" and noting that several related lawsuits are currently being litigated).


\textsuperscript{157} Id.

\textsuperscript{158} Id.

\textsuperscript{159} Id.

\textsuperscript{160} At least one virtual stock exchange has noted that it is not intended for gambling. SL Capital Exchange, Terms of Service, http://www.slcapex.com/content/tos (last visited Nov. 9, 2000), ("The CAPEX exchange is a game of skill that allows participants to profit from evaluating the performance of companies in the Second Life virtual economy. It is not intended as a gambling or investing tool.").

\textsuperscript{161} Crosman, supra note 82 ("There's no difference between [trading on a virtual exchange] and going to a gaming parlor, paying money to a machine that lets you play pretend stocks, and if you win you get paid back tokens, which someone might then buy from you.").

\textsuperscript{162} Id.

While both gambling and investing involve risk-taking, only investing involves "risk-shifting or other legitimate economic benefits."164 Investing offers financial opportunities to individuals as well as businesses by providing potential for wealth building.165 Stock markets afford businesses the opportunity to raise capital, which increases productivity and is beneficial to society.166 Stock markets' liquidity further reduces the cost of capital and encourages investment in financial assets.167 When investors buy financial assets, they purchase a claim on the business's real assets and the cash those assets will produce.168 Investing increases society's overall wealth because the capital invested in financial assets funds businesses that exist for the purpose of producing goods or services.169 Unlike gambling payouts, the value of stocks trend upward over time.170

While investing is considered productive, gambling is not generally viewed as providing any tangible economic benefit beyond providing entertainment value.171 Gambling does not allow businesses to raise additional capital.172 Instead of increasing society's aggregate wealth, gambling only redistributes wealth.173 Because the value of a stock will increase over time, no one loses money as a result of shareholder profit.174 Gambling, however, is a zero-sum game in which every dollar won is a dollar lost by another participant.175

Virtual world investing is, arguably, an economically productive activity which does not involve mere wealth redistribution like gambling. Just as real world corporations issue stock in the primary market for corporate equity by selling shares to investors in exchange for additional capital,176 virtual world corporations issue stock for the same rea-

---

164 Id.
166 Hazen, supra note 163, at 377.
167 See Lynn A. Stout, Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation, 81 Va. L. Rev. 611, 683 (1995) (discussing liquidity and its effect on markets). Liquidity is the extent to which an investor is able to buy or sell an asset in the market without affecting its price by having to offer a discount. Id.
168 Richard A. Brealey et al., Principles of Corporate Finance 6-7 (8th ed. 2006).
169 Glett, supra note 165, at 53.
170 Id.
171 Hazen, supra note 163, at 377.
172 Glett, supra note 165, at 53.
173 Id.
174 Id.
175 Id.
176 See generally Brealey et al., supra note 168, at 388 (discussing venture capital and the IPO). When a corporation sells securities in order to raise additional capital, the securi-
Consider, for example, Vlada Fine Furniture & Fixtures (VLADA), a virtual furniture company listed on the International Stock Exchange. Vlada issued stock to raise additional capital in order to “[l]aunch an aggressive advertising campaign that will create brand awareness” and to purchase real estate to launch an outlet store. Investing in Vlada stock is a productive activity because Vlada is producing a good, albeit a virtual one. While there is not yet evidence to indicate that the value of virtual stocks trends upward over long periods of time, there is evidence that the value of individual stocks have trended upward over a short period of time.

When an investor purchases a share of stock in a virtual company, the investor purchases a proportional claim to the virtual business’s assets upon liquidation. For example, when Dragon Global Diversified (DGD) dissolved its virtual business, it liquidated and transferred its cash assets to its shareholders. Liquidity reduces the cost of capital and encourages investors to invest in the financial assets of virtual businesses. When an in-world investor invests in a virtual world business, the investor’s profits are derived from the success of the virtual business. Therefore, investing on the Second Life virtual stock exchanges does not rely on chance to determine a winner.

IV. Should the SEC Regulate Virtual World Securities?

Because the federal securities laws likely apply to issuances of virtual world securities, issues arise concerning which laws apply and how their application will affect virtual investing. In determining how to best regulate virtual securities, the SEC should consider the burden of regulations are sold in the “primary market.” Id. at 375. Financial markets allow investors to trade securities among themselves in the “secondary market.” Id.

See supra note 37.

Vlada Fine Furniture & Fixtures, supra note 53.

Id.

Id.

See supra notes 87, 116 text accompanying.

See Posting of Maelstrom Baphomet to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See supra notes 87, 116 text accompanying.

Dragon Global Diversified, supra note 181.

See Posting of Maelstrom Baphomet to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Maelstrom Baphomet to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Lex Fitzcarraldo to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Lex Fitzcarraldo to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Lex Fitzcarraldo to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Lex Fitzcarraldo to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Lex Fitzcarraldo to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Lex Fitzcarraldo to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Lex Fitzcarraldo to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Lex Fitzcarraldo to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).

See Posting of Lex Fitzcarraldo to http://www.freewebs.com/maelstrom79/ (last visited Apr. 28, 2008) (indicating that, upon closing the business after 8-9 months of operation and liquidating, the virtual company’s stock had grown by approximately 25% from its IPO value).
lation costs to virtual issuers, the amount of money involved in the virtual transactions, the benefits that the unregulated virtual markets provide, and the self-regulatory measures developing in the virtual worlds.

A. Real World Registration Costs Outweigh the Benefits of Virtual Offerings

The registration requirements under the Securities Act apply to virtual world issuances. And, taking into account the offering and purchasing activity in the U.S., stock issuances on virtual exchanges do not qualify for any of the federal securities registration exemptions. For instance, Regulation A, which exempts small offerings from registration, is only available to "an entity" organized under the laws of the U.S. or Canada or its states or territories and would not be available to virtual world issuers. Even if virtual offerings would be exempt from registration under Regulation A, the issuer must still provide purchasers with an "offering circular" similar to a real world prospectus.

Requiring registration of virtual world offerings under current federal securities laws would likely result in the disappearance of the virtual markets. This is because the cost of registration is often hundreds of thousands of dollars, whereas the amount raised in virtual world public offerings is significantly less. One issuer, listed on the SL Capital Exchange, offered 578,167 shares at $L5 or about $.02 U.S. dollars

---

187 See BLOOMENTHAL, supra note 72, at § 6:20 (discussing the Securities Act of 1933). Under the Securities Act, an issuer must file a registration statement with the SEC and provide investors with a detailed prospectus prior to a public offering. Id. The Exchange Act of 1934, which extends the disclosure regime for public offerings to public trading of securities, would not apply to virtual issuances because it is limited to companies with more than $10 million in assets and more than 500 shareholders. See BLOOMENTHAL, supra note 72, at § 12:13 (discussing the Exchange Act). While the virtual exchanges are likely to be categorized as an over-the-counter (OTC) market, further analysis of this is beyond the scope of this Article.

188 Swan, supra note 61.


190 See Bradley, supra note 45, at 20-21. ("[C]orporations can only be created by licence [sic] from states . . . [T]he corporations that exist in VWs are mostly . . . virtual entities that have only slight claims to be regarded as corporations.").


per share in an IPO.194 Depending on exchange rate, this issuer raised capital between $11,000-$12,000 U.S. dollars.195 Because the cost of going public under the real world securities laws far exceeds $12,000, enforcement of the securities laws will deter businesses from raising capital on the virtual exchanges.196

If registration were required despite these concerns, the SEC might consider creating a separate exemption for virtual securities.197 Like other exempt offerings, virtual securities would still be subject to the anti-fraud provisions of the securities laws.198 Just as the SEC created Regulation A and Rules 504 and 505 of Regulation D, it could create an exemption for virtual securities offerings under its §3(b) authority.199 In creating an exemption, the SEC would need to avoid the imposition of requirements that could be overly burdensome to virtual world issuers. While simply requiring notice of the offering might not be burdensome, requiring issuers to provide an offering circular would likely create costs that would outweigh the benefit of the public offering.200 An SEC exemption may also serve to better the reputation of the virtual world securities markets, which could attract more serious traders and provide a valuable "test tube" for research on regulation.

B. Regulation Will Stifle Valuable Research Opportunities

Regulation of virtual securities offerings would likely stifle innovation and the potential for valuable research.201 Virtual worlds such as

194 Id.
195 Id.
196 See id. (discussing the small amount raised by a virtual world issuer).
197 Bradley, supra note 45, at 29-30 (suggesting the SEC create an exemption and consider criteria such as the amount of the player’s investment and the player’s sophistication).
199 The Securities Act of 1933, § 3(b) ("The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000.").
200 See supra note 191 (discussing the offering circular required for exempt offerings under Regulation A).
201 See Bryan Gardiner, Bank Failure in Second Life Leads to Calls for Regulation, WIRED, Aug. 15, 2007, http://www.wired.com/gaming/virtualworlds/news/2007/08/virtual_bank (quoting Richard Bloomfield) ("I am really hoping that RL (real life) regulation does not come to SL because right now SL has the chance to sort out what type of oversight and regulation it wants. . . . If the RL authorities or Linden Lab do start meddling with business affairs, it could ruin a golden opportunity for real innovation and creativity, a chance to recreate a world in a new image.").
Second Life have recently attracted the attention of social scientists and other academics. The growth in the population of virtual worlds as well as the scope and nature of their socio-economic activities make them attractive to researchers. Virtual worlds have developing cultures and social institutions that are increasingly viewed as beneficial to society. The growing economies of virtual worlds, which engage in virtual production, virtual consumption, and virtual trade in their own convertible currencies, also raise traditional research questions in economics. Researchers are interested in new business models and practices that arise from the unique nature of virtual world businesses.

Researchers have found that Second Life can be a valuable research platform or test tube. Virtual worlds provide unique methods for study because they allow researchers to control the environment in which individuals interact and make decisions. Research has further found that the virtual world environment can simulate most of the necessary features of a physical laboratory at much lower costs. Market research has also become increasingly popular in the virtual world, and marketers are currently testing advertising campaigns, product packaging, and consumer satisfaction. Commentators have noted that research in Second Life's financial and business sectors can provide valuable insight as to the nature of regulation and oversight.

203 Id.
204 Id.
205 Id.
206 Id.
207 See Francesca Di Meglio, Theory Meets Practice Online, BUSINESSWEEK, July 24, 2007 ("Business school professors and economics researchers are turning to . . . virtual worlds as dynamic laboratories to shed light on some of the venerable mysteries of economic behavior.").
208 Chesney et al, supra note 202, at 25.
209 Id.
210 See Di Meglio, supra note 207 (indicating that Pepsi tracks the use of its products in the virtual world There.com and Starwood Hotels tested the designs of its new lofts in Second Life). Some critics, however, have questioned the validity of demographic information collected in online market research. See, e.g., John Duffy, Trust in Second Life, (2008), available at http://www.pitt.edu/~jduffy/papers/TrustinSL.pdf (discussing issues raised with regard to conducting decision-making experiments in virtual worlds).
211 Gardiner, supra note 201; see also Chris Gaylord, Can Web-Based Worlds Teach Us About the Real One?, THE CHRISTIAN SCIENCE MONITOR, Jan. 23, 2008, http://www.csmonitor.com/2008/0123/p13s01-stct.html (describing research supported by the Financial Accounting Standards Board that will study the effect of legislation and public policy by utilizing virtual world stock markets).
C. Self-Regulation May Be Sufficient

1. The Current State of Self-Regulation

A strong securities market depends on a network of institutions to ensure that minority shareholders: (1) receive sufficient information about the value of the company; and (2) have confidence that the company’s managers and controlling shareholders will not defraud them out of investment returns. To ensure that investors receive material information when issuers sell securities in public markets, virtual worlds are moving toward the development of better methods of self-regulation. The Second Life Exchange Commission is a group that develops strict listing requirements, standards of performance, and ethics rules for virtual world market participants. Second Life residents have also established a virtual world Better Business Bureau. While current self-regulatory measures are far from perfect or impartial, there is evidence the market is adapting quickly and may continue to organically protect against fraud. Virtual stock markets have also heeded advice from the academic community by implementing anti-fraud measures such as requirements that listed companies carry insurance and provide regular financial updates to investors.

215 See Benjamin Durankse, Virtually Blind, Feb. 19, 2007, http://virtuallyblind.com/2007/02/19/second-life-in-world-attorney-monday-beam-hired-for-land-dispute-expects-settle-ment-attorney-fees/ (indicating that groups such as the Second Life Better Business Bureau are regularly created and “usually amount[] to whitelisting themselves and their buddies, and blacklisting others they don’t like”).
217 See Francesca Di Meglio, Virtual World Exchanges Get Real, BUSINESSWEEK, Aug. 10, 2007, http://www.businessweek.com/print/technology/content/aug2007/tc2007089_873900.htm (“[The] SL Capital Exchange . . . plans to offer extensive disclosure of trading data and to adopt listing requirements recommended by Robert Bloomfield, a professor at Cornell University’s Johnson Graduate School of Management . . . . [R]ecommended policies include weekly and monthly financial updates by listed companies and a requirement they carry virtual insurance.”).
2. Trust Networks

Effective trust networks in virtual worlds will inform investors, guard against fraud, and potentially keep the SEC away from the markets. Trust is a key aspect in maintaining the connections between individuals transacting over the internet.\textsuperscript{218} Trust in the knowledge and capability of community members builds quickly when members actively contribute to a project’s success and others can see their contributions measured concretely, such as through a rating system.\textsuperscript{219} Three successful approaches to building trust include: (1) compiling multiple transactions; (2) adequately reducing risk from transactions; and (3) utilizing the power of social networks.\textsuperscript{220}

EBay successfully built trust among buyers and sellers by developing a reputation system that compiles data from numerous transactions.\textsuperscript{221} Buyers and sellers value the reputation system so much that they are willing to invest their time and money in dispute resolution to avoid a negative rating.\textsuperscript{222} A successful reputation system, like eBay’s, must encourage users to be trustworthy, discourage untrustworthy users from participating, and provide information from which users are able to detect trustworthy sellers.\textsuperscript{223}

Virtual world exchanges could establish a reputation system similar to that employed by eBay. Buyers and sellers of virtual securities could rate one another, and data could be compiled regarding the length of time a stock is held, trading volume, or speed of payment. Traders could improve their overall ratings by holding securities for longer periods of time, paying promptly, or participating in shareholder voting. Virtual companies could increase their overall ratings by providing regular and accurate financial reports, holding regular shareholder meetings, and otherwise increasing transparency and honesty.

Trust may also be built in virtual world markets if the risk to investors is reduced. Trust developed in online shopping because credit card companies reduced the risk to consumers by assuming financial liabilities arising from unsatisfactory online transactions.\textsuperscript{224} Starting in 1933,
the U.S. government established trust in banks and savings associations by providing FDIC insurance, which now insures deposits in checking, savings, money market accounts, and certificate of deposits up to $100,000.225 Amid the recent credit crisis, the U.S. Treasury has insured nonbank money market deposits, creating greater trust in investors and reducing the number of money-fund redemptions.226 In the virtual world markets, risk to investors may be reduced if the exchanges or virtual issuers provide an analogous full or partial insurance or risk fund.

Building trust could also come in the development of networks such as Facebook, an online social network based on the premise that a stranger deserves more trust when he or she is a friend of a friend.227 Virtual issuers and traders could utilize social networks by choosing to deal with those in their social network first, rather than with unconnected strangers.

In virtual worlds, users could further leverage these approaches to building trust by combining them with the power of avatars.228 Trust in the issuers, exchange operators, and the investors may prevent fraud and encourage investment. Linden Lab might also build trust by running a virtual exchange or acting as a regulatory body charged with overseeing exchange activities.229 Users would trust Linden Lab to run an exchange because it would be able to protect investors against fraud by utilizing mechanisms to track transactions and enforcement procedures.230


227 Id. at 39-40.

228 Id. at 40. Individuals are more likely to trust dealings with avatars than with “less embodied forms.” Id.; See also Jonas Heide Smith, Avatars You Can Trust—A Survey on the Issues of Trust and Communication in MMORPGs, GAME RESEARCH, Sept. 10, 2006, http://game-research.com/index.php/articles/avatars-you-can-trust-a-survey-on-the-issue-of-trust-and-communication-in-mmorpgs/ (describing research on how trust is gained among avatars). The idea that individuals are more likely to trust avatars is important because “it means that systems emerging within virtual worlds can generate more influence between members than similar systems created on the web.” Ondrejka supra 216 at 40.

229 See Linden Stock Exchange, YOUR SECOND PLACE, July 26, 2007 http://www.your2ndplace.com/node/277 (“People who can actually track transactions, run fraud checks, report dodgy dealings directly to the police and at least theoretically have the clout to enforce good practice running a Stock Exchange.”).

230 Id.
V. Conclusion

Virtual securities are likely securities for purposes of the federal securities laws. Virtual stock is "stock" under the federal securities laws because it bears the typical characteristics of stock—dividend rights, liquidity rights, proportional voting rights, negotiability, and capital appreciation potential. Under the Howey test, virtual stock is also an investment contract, and thus, a security. Disclaimers and marketing efforts that proclaim such investment activities are part of a "game" will not provide protection from the securities laws. Further, investing in virtual companies is not a game in the sense that it is not akin to gambling.

Although virtual securities are subject to the federal securities laws, the SEC should consider abstaining from enforcement. Virtual worlds, and specifically the virtual financial markets, have potential for unique research opportunities. Better methods of virtual world self-regulation, such as the development of effective trust networks or risk reduction methods, will serve to ensure that investors receive information about a company's business and are protected from fraud.