

Securities Regulation in a Virtual World

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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 Millions² of individuals participate in “virtual worlds,” which are computer-based interactive environments that simulate real life.³ The broad term “vir-

¹ Bobby Glushko, *Tales of the (Virtual) City: Governing Property Disputes In Virtual Worlds*, 22 BERKELEY TECH. L.J. 507, 507 (2007).

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*, METAVERSED, 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.”).

³ See Edward Castronova, *Virtual Worlds: A First-Hand Account of Market and Society on the Cyberian Frontier* 6 (Ctr. for Econ. Studies & Ifo Inst. for Econ. Research, Working Paper No. 618, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=294828 (“[P]eople access the [computer] program through an interface that simulates a first-person physical environment” that is “ruled by the natural laws of Earth.”). Beyond this broad definition, commentators disagree as to what constitutes a “virtual world.” See Richard A. Bartle, *Virtual Worldliness*, IN THE STATE OF PLAY: LAW, GAMES AND VIRTUAL WORLDS 34

tual world” includes community and commerce-focused worlds like Second Life.⁴ 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 (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;⁶ (7) social interaction, allowing in-world social groups such as clubs or neighborhoods; and (8) the use of an “avatar.”⁷ An “avatar,” a graphical representation of the user,⁸ may look like a human, animal, mythical creature, or any other representation the software allows.⁹ Some users create avatars that resemble their

(Jack M. Balkin & Beth S. Noveck ed., 2006) (distinguishing between virtual worlds and games); Robert Bloomfield, *Virtual Worlds for Study: Invitation - Virtual Worlds for Studying Real-World Business (and Law, and Politics, and Sociology, and . . .)* 16 (May 25, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=988984 (defining “virtual worlds” to include non-Internet based games); Caroline Bradley & A. Michael Froomkin, *Virtual Worlds, Real Rules*, 49 N.Y.L. SCH. L. REV. 103, 121 (2005) (using the terms “virtual worlds” and “MMORPGs” (massively multi-player online role-playing games) interchangeably).

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 gambit 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.”).

⁷ Virtual Worlds Review, What is a Virtual World?, <http://www.virtualworldsreview.com/info/whatis.shtml> (last visited Apr. 28, 2008).

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.¹⁰

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.¹¹ Described as “an animated version of real life,”¹² 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.¹³ 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.¹⁴

Second Life was developed by the California-based corporation Linden Lab.¹⁵ 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.¹⁶ 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.¹⁷ 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”).

¹⁰ Alemi, *supra* note 5, at ¶ 19; *see also* Bloomfield, *supra* note 3, at 9 (naming his avatar BeyersSellers, which is indicative of his career as an economics professor at Cornell University’s business school); *see also* Robert Bloomfield, *Second Life Financial Markets Panel a “Smashing Success,”* METAVERSED, July 17, 2007, <http://metaversed.com/robert-bloomfield/blog/16-jul-2007/second-life-financial-markets-panel-smashing-success/> [hereinafter *Second Life Financial Markets Panel a “Smashing Success”*] (indicating that “TraderJohn Susa” heads the Second Life Exchange Commission).

¹¹ Second Life, What is Second Life?, <http://secondlife.com/whatis/> (last visited Mar. 27, 2008).

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

¹³ *See generally* Second Life, Create an Avatar, <http://secondlife.com/whatis/avatar.php> (last visited Apr. 2, 2008).

¹⁴ *See generally* Second Life, Meet People, <http://secondlife.com/whatis/meet.php> (last visited Apr. 2, 2008).

¹⁵ Linden Lab, The Company, <http://lindenlab.com/about> (last visited Apr. 2, 2008).

¹⁶ Robert Bloomfield, *Second Life: The First Entrepreneurial Virtual World*, NATIONAL POST, Apr. 8, 2008, at A16 [hereinafter *The First Entrepreneurial World*]. By renting virtual land, users are given “space on Linden Lab’s computer servers.” *Id.*

¹⁷ What is Second Life?, *supra* note 11.

bring their digital creations to life.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.¹⁹ Linden Lab's unique business model has attracted a flourishing community of entrepreneurs to Second Life.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.²¹ Dubbed as "the first 'entrepreneurial virtual world,'"²² Second Life's economy has even allowed one resident, a virtual real estate mogul, to make over \$1 million U.S. dollars.²³

1. The Economy of Second Life

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

¹⁸ *The First Entrepreneurial World*, *supra* note 16.

¹⁹ See Second Life, Policies & Guidelines, <http://secondlife.com/policy/> (last visited Apr. 2, 2008) (providing "community standards," information on trademark usage, and other policies and guidelines).

²⁰ *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, ha[ve] a median age in the 30's, and most . . . live outside of the United States." Cory Ondrejka, *Collapsing Geography: Second Life, Innovation, and the Future of National Power*, 2 INNOVATIONS: TECHNOLOGY, GOVERNANCE, GLOBALIZATION 27, 32 (2007).

²¹ Albert Lin, *Virtual Consumption: A Second Life for Earth?*, 2008 BYU L. REV. 47, 82 (2008).

²² *The First Entrepreneurial World*, *supra* note 16.

²³ Roger Parloff, *Anshe Chung: First Virtual Millionaire*, CNNMoney.com, Nov. 27, 2006, <http://money.cnn.com/blogs/legalpad/2006/11/anshe-chung-first-virtual-millionaire.html>.

²⁴ Lin, *supra* note 21, at 82.

²⁵ Second Life, IP Rights, http://secondlife.com/whatis/ip_rights.php (last visited Feb. 27, 2008); 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.").

²⁶ Second Life, The Marketplace, <http://secondlife.com/whatis/marketplace.php> (last visited Feb. 27, 2008) ("Make real money in a virtual world. That's right, REAL MONEY.").

niture store owner.²⁷ While it is free to join Second Life, it generally costs money to participate in virtual transactions.²⁸

Users can buy and sell their virtual products and services in Second Life with Second Life's virtual currency, the Linden.²⁹ The Linden is "[a]n internal unit-of-trade with real market value,"³⁰ 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.³¹ The Linden facilitates commerce in Second Life's virtual world economy.³² Residents who earn virtual money in Second Life can exchange their virtual currency for legitimate currency.³³ Estimates of real-money trade (RMT) of virtual goods and services range from \$5 to \$901 million USD.³⁴

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

²⁷ Second Life, Business Opportunities, <http://secondlife.com/whatis/businesses.php> (last visited Feb. 27, 2008); see *infra* notes 53, 178-180 (describing a virtual furniture store).

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 Linden™ dollar, which can be converted to US dollars at several thriving online Linden dollar exchanges.").

²⁹ Second Life, Economy, <http://secondlife.com/whatis/economy.php> (last visited Mar. 20, 2008).

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 Linden™ dollar, which can be converted to US dollars at several thriving online Linden dollar exchanges.").

³² *The First Entrepreneurial World*, *supra* note 16.

³³ What is Second Life?, *supra* note 11. But see *Speculating on Second Life's Virtual Economy Woes*, VIRTUAL WORLDS NEWS, July 31, 2007, <http://www.virtualworldsnews.com/2007/07/second-lifes-mo.html> (describing one researcher who "'could buy lindens at about the same price as always, but trying to sell even a moderate number of Lindens would get a far worse price. . . . [P]eople aren't trying to cash out . . . because the market simply isn't liquid enough to bear it'"); Randolph Harrison, *Second Life: Revolutionary Virtual Market or Ponzi Scheme?*, CAPITALISM 2.0, Jan. 23, 2007, http://randolfe.typepad.com/randolfe/2007/01/secondlife_revo.html (describing his difficulty in converting large amounts of virtual currency into real world currency); see also Edward Castronova, *SL Economy Misunderstood Again*, Terra Nova, Jan. 26, 2007, http://terranova.blogs.com/terra_nova/2007/01/sl_economy_misu.html ("[T]he SL economy is not as liquid as, say, the economy of the United States.").

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_anyw. 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.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.³⁶ Virtual exchanges give virtual business owners the ability to raise capital by selling shares in their virtual companies.³⁷ The virtual companies are business operations controlled by avatars and residents in the virtual world and do not exist as real world corporations.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.³⁹ Stock exchanges currently operating in Second Life include⁴⁰ the SL Capital Exchange (SLCAPEX)⁴¹, the World Stock Exchange (WSE),⁴² the Virtual Stock Exchange (VSTEX),⁴³ and the International Stock Exchange (ISE).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.⁴⁵ Issuers provide investors with a so-called "prospectus" that includes information such as "risk factors."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.⁴⁷ Risks stemming from the general nature

³⁵ BENJAMIN TYSON DURANSKE, *VIRTUAL LAW: NAVIGATING THE LEGAL LANDSCAPE OF VIRTUAL WORLDS* 218 (2008).

³⁶ *Id.*

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.").

³⁸ World Stock Exchange, Terms of Service, <http://www.wselive.com/info/tos> (last visited Apr. 2, 2008).

³⁹ *See supra* note 37.

⁴⁰ *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.").

⁴¹ SL Capital Exchange, <http://www.slcapex.com/> (last visited Apr. 11, 2008).

⁴² *See* World Stock Exchange, *supra* note 37.

⁴³ Virtual Stock Exchange, VSTEX, <http://www.vstex.net/> (last visited Apr. 11, 2008).

⁴⁴ International Stock Exchange of Second Life, <http://www.intlstockexchange.com/> (last visited Apr. 6, 2008).

⁴⁵ Caroline Bradley, *Gaming the System: Virtual Worlds and the Securities Markets* 21 (Univ. of Miami Legal Studies Research, Paper No. 2007-10, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1022441.

⁴⁶ *See, e.g.*, SL Capital Exchange, POW: Sky Power Fund, Prospectus, <http://www.slcapex.com/symbol/POW/profile> (last visited Apr. 4, 2008) [hereinafter POW Prospectus] (listing a "[c]ollapse of the banking infrastructure" as a risk factor).

⁴⁷ *See infra* notes 48-54 and accompanying text (providing examples of such risk factors).

of Second Life include a collapse of Linden Lab,⁴⁸ server downtime,⁴⁹ and a lack of predictability as to the future popularity of Second Life.⁵⁰ Risks for all listed companies include a collapse of the virtual stock markets,⁵¹ competition,⁵² and the market's rejection of a brand.⁵³ Risks specific to particular issuers include the risk that Linden Lab will implement an age verification system.⁵⁴

Virtual world issuers often include measures to protect against the risk factors specified in their prospectuses.⁵⁵ 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.⁵⁶ Similarly, a virtual retail company may protect against the risk of static sales by hiring a marketing firm to aid in branding.⁵⁷ A virtual media and entertainment company retained a Second Life law firm to protect itself in real world and Second Life matters.⁵⁸ 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.

⁴⁹ World Stock Exchange, SL Marketing, Prospectus, <http://www.wselive.com/research/prospectus/> (last visited Apr. 2, 2008) [hereinafter SL Marketing Prospectus].

⁵⁰ World Stock Exchange, Logo Coding, Prospectus, <http://www.wselive.com/research/prospectus/80> (last visited Apr. 2, 2008) [hereinafter Logo Coding Prospectus].

⁵¹ POW Prospectus, *supra* note 46.

⁵² SL Marketing Prospectus, *supra* note 49.

⁵³ International Stock Exchange, Vlada Fine Furniture & Fixtures, <http://www.intlstockexchange.com/CompanyProfile.php?id=25> (last visited Apr. 4, 2008) [hereinafter Vlada Fine Furniture & Fixtures].

⁵⁴ SL Capital Exchange, XXX: Tropical Temptations, <http://www.scapex.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.

⁵⁸ SL Capital Exchange, MNM: MetaNetwork Media, Prospectus, <http://www.scapex.com/symbol/MNM/profile> (last visited Apr. 9, 2008) ("MetaLegal is a SL Law Firm devoted to their clients in the services of intellectual property, trademarks, legal counseling on business opportunities, strategic alliances and joint ventures."). Although some real world lawyers and law firms practice in Second Life, others have expressed concern about real world issues with bar rules, such as conflicts of interest or solicitation rules. Attila Berry, *Lawyers Find Real Revenue in Virtual World*, LEGAL TIMES, July 31, 2007, <http://www.law.com/jsp/legaltechnology/pubArticleLT.jsp?id=1185820702695>. The Second Life Bar Association is developing an attorney verification system so that clients will be aware of whether their in-world attorney is qualified to practice law in the real world. Second Life Bar Association, Meeting Transcript, Aug. 11, 2007, http://www.slba.info/2007_08_11_Transcript.htm.

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 Goldflake, 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 nor 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).

⁶¹ Melanie Swan, *Unregulated Stock Exchanges in Second Life*, BROADER PERSPECTIVE, Oct. 29, 2007, <http://futurememes.blogspot.com/2007/10/unregulated-stock-exchanges-in-second.html>; *see also supra* note 60 (discussing disclosure requirements).

⁶² Swan, *supra* note 61. While listed companies generally do not employ professional accountants now, this may change as the virtual exchanges create stricter reporting requirements. *See A New Virtual Accounting Company in Second Life*, SLREPORTS.NET, Mar. 9, 2008, <http://sl-virtual-world-news.com/index.php/Opinions/iVentures-Volitant-s-Blog/A-New-Virtual-Accounting-Company-in-Second-Life.html> (describing SL Financial Reporting Group, a new in-world accounting company “created to meet the financial reporting needs for business owners, as well as any special financial service needs from the Exchanges within Second Life.”).

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.”⁶⁶ The Virtual Stock Exchange requires business models be based on the virtual world, dealing in virtual products.⁶⁷

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.⁶⁸ Neither the U.S. Securities and Exchange Commission nor a foreign equivalent currently regulates investing activities in virtual worlds.⁶⁹ While there are self-regulatory bodies in Second Life, such as the Second Life Exchange Commission, these groups do not have any legal authority.⁷⁰ 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.⁷¹ 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.⁷² The definition of a security is expansive, in-

⁶⁶ World Stock Exchange, Listing Rules, <http://www.wselive.com/info/rules> (last visited Mar. 12, 2008).

⁶⁷ Vstex, Listing Rules, <http://www.vstex.net/?p=89> (last visited Mar. 23, 2008) (requiring “business models [be] entirely based on the metaverse, dealing with virtual goods and commodities”).

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 pseudoanonymous 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.”).

⁷² HAROLD S. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* § 2:1 (2007). Though there are some differences, the basic definition of a security is the same under the Securities Act of 1933, the Securities Exchange Act of 1934, and state blue sky laws. *Id.*; see also Securities Act of 1933 § 2(a)(1) (codified at 15 U.S.C. § 77b(a)(1) (2000)); Securities Exchange Act of 1934 § 3(a)(10) (codified at 15 U.S.C. § 78c(a)(10) (2000)); Uniform Securities Act § 401(1).

cluding both enumerated financial instruments, such as stocks and bonds, and general catchall terms, such as “investment contracts” and “evidence of indebtedness.”⁷³ 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.”⁷⁴ 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.⁷⁵ Characteristics typically associated with stock include dividend rights, liquidity rights, proportional voting powers, and appreciation potential.⁷⁶ Where the so-called security bears these typical characteristics, “a purchaser justifiably [may] assume that the federal securities laws apply.”⁷⁷

In *United Housing Foundation, Inc. v. Forman*, the Supreme Court first applied the “stock characteristics test” to determine when securities laws might apply.⁷⁸ 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.⁷⁹ 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.⁸⁰ Without the typical characteristics of stock, the federal securities laws did not apply.⁸¹

In contrast to the “stock” in *Forman*, however, virtual stock bears characteristics typically associated with stock.⁸² One such characteristic is that stockholders’ right to receive dividends contingent upon an apportionment of profits.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.”⁸⁴ Shareholders in the virtual world can also realize a profit when their shares appreciate in value.⁸⁵ Shareholders have proportional voting rights⁸⁶ and liquidity rights.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-

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² See Penny Crosman, *Virtual Stock Exchange Opens in Second Life*, 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”).

⁸³ See, e.g., SL Capital Exchange, DCTY: Dreamcities.net, Prospectus, <http://www.slcapex.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.”).

⁸⁴ Tropical Temptations, *supra* note 54.

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”).

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).

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.”).

tively decide to analyze virtual stock under the investment contract rubric.⁸⁸

B. *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.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.⁹⁰ Whether virtual stock is considered a security could therefore depend on whether it fits under the definition of an investment contract.⁹¹

1. The *Howey* Test for Investment Contracts

In *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.”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.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.⁹⁴ Thus, the securities laws cannot be avoided merely by calling a financial arrangement by a non-enumerated term.⁹⁵

⁸⁸ The investment contract analysis normally applies only after the “stock” fails the stock characteristics test. DAVID A. LIPTON, 15 *BROKER-DEALER REG.* § 1:48 (2007).

⁸⁹ BLOOMENTAL, *supra* note 72, at § 2:1.

⁹⁰ *Id.* at § 2:1; *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).

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

⁹² *Id.* at 298.

⁹³ *Id.* at 298-99.

⁹⁴ Forman, 421 U.S. at 851-52.

⁹⁵ *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.”); *see also* 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.⁹⁶ The SEC brought enforcement proceedings related to a scheme in which individuals purchased small tracts of land in a Florida citrus grove.⁹⁷ 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.⁹⁸ 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.⁹⁹ The Court held that such arrangements are investment contracts “regardless of the legal terminology in which such contracts are clothed.”¹⁰⁰ 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.¹⁰¹

Courts have applied the *Howey* test in a wide range of contexts.¹⁰² 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,¹⁰³ chinchilla breeding with a resale agreement,¹⁰⁴ 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.¹⁰⁵ In each instance, individuals had invested money with the expectation of profits to be derived predominantly from the efforts of the promoter.¹⁰⁶ 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.¹⁰⁷

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 BLOOMENTAL, *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).

¹⁰⁴ *Miller v. Cent. Chinchilla Group*, 494 F.2d 414, 415-18 (8th Cir. 1974).

¹⁰⁵ *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 474 (5th Cir. 1974).

¹⁰⁶ BLOOMENTAL, *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.”¹⁰⁸ The investment does not have to take the form of cash, but rather may be “some tangible and definable consideration.”¹⁰⁹ Virtual world investments do not involve direct cash investments, but rather investments of virtual world currencies.¹¹⁰ Some commentators argue that virtual currency has value if it can be easily converted into real world cash.¹¹¹ 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.¹¹²

ii. Common Enterprise

A common enterprise exists where there is horizontal commonality, which is satisfied if investors retain interrelated interests in a common scheme.¹¹³ 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.¹¹⁴ 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.slapex.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.¹¹⁵ The investors' contributions are pooled and the profits and losses are distributed pro-rata among the investors.¹¹⁶

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."¹¹⁷ Capital appreciation and earnings differ from transactions in which an individual is motivated to purchase a commodity for use or consumption.¹¹⁸ In the context of investing in shares of virtual world companies, the investments offer both dividends and appreciation potential.¹¹⁹ Some issuers make statements practically guaranteeing profit to virtual world investors.¹²⁰ 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.¹²¹ 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").

¹¹⁷ United Housing Found., Inc. v. Forman, 421 U.S. 837, 852 (1975).

¹¹⁸ *Id.* at 858.

¹¹⁹ See Connie McMahon, The Second Life Newspaper Finance: Weekly Business Review-29 Oct 07, <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").

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.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.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.¹²⁴ Virtual world stock markets, however, emphasize that they are just a “game.”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.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 *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.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.¹²⁸ The website displayed a disclaimer, alerting prospective users that they would be playing a game and not making an investment.¹²⁹ SG arbitrarily set the stock price and promised users that they would be able to buy and sell any amount of

¹²² *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir. 1973); see also BLOOMENTHAL, *supra* note 72, at § 2:2 (describing the shift away from a literal interpretation of “solely”).

¹²³ See, e.g., SL Capital Exchange, MNM: MetaNetwork Media, Prospectus, <http://www.slcapex.com/symbol/MNM/profile> (last visited Apr. 15, 2008) (describing its management team and the responsibilities of each member with regard to running its media business).

¹²⁴ Bradley, *supra* note 45, at 25.

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).

¹²⁶ Bradley, *supra* note 45, at 21.

¹²⁷ *SEC v. SG Ltd.*, 265 F.3d 42, 55 (1st Cir. 2001).

¹²⁸ *Id.* at 44. The listed companies did not exist in the real world. *Id.*

¹²⁹ *SEC v. SG Ltd.*, 142 F.Supp.2d 126, 128 (D. Mass. 2001).

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

SG, however, manipulated the virtual stock market, causing shares in all of the companies to decrease dramatically.¹³² SG prevented users from being able to withdraw any funds from the game.¹³³ At least 800 U.S. investors had paid more than \$7 million.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.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.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.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.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.¹³⁹ On appeal, the First Circuit only considered whether the facts alleged in the complaint were sufficient to merit a trial.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.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.¹⁴² It rejected the district court's distinction between "commercial dealings," which are subject to the securities

¹³⁰ *SG Ltd.*, *supra* note 128, at 44.

¹³¹ *Id.*

¹³² *Id.* at 44-45.

¹³³ *Id.* at 45.

¹³⁴ *Id.*

¹³⁵ *Id.*

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.

¹³⁷ *Id.* at 44.

¹³⁸ *Id.*

¹³⁹ *SG Ltd.*, *supra* note 130, at 130-31.

¹⁴⁰ *SG Ltd.*, *supra* note 128, at 46.

¹⁴¹ *Id.*

¹⁴² *Id.* at 55.

laws, and “games,” which are not.¹⁴³ The First Circuit noted that, as long as the *Howey* test is satisfied, the instrument must be characterized as an investment contract.¹⁴⁴

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.¹⁴⁵ 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.¹⁴⁶ The alleged facts led to a finding of horizontal commonality, which the court found sufficient to satisfy the common enterprise requirement.¹⁴⁷ Pooling was established by SG’s representations on its website that it accumulated players’ money into one account to settle transactions.¹⁴⁸ Each investor was entitled to share in profits proportional to his or her investment.¹⁴⁹ 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.¹⁵⁰ 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.¹⁵¹

In light of these considerations, the First Circuit reversed and remanded the case,¹⁵² 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.¹⁵³ 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.¹⁵⁴ 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. Tippet, 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.

¹⁵³ See *SEC v. SG Ltd.*, Civ. Action No. 00-11141-GAO (D. Mass. May 28, 2003) (indicating that the parties filed a “Consent to Final Judgment of Permanent Injunction, Disgorgement and Other Relief” and settled the SEC’s claim for \$1.33 million).

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.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.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."¹⁵⁷ The games must also give a payout in virtual world currency, real world currency, or anything of value.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.¹⁵⁹

The virtual world exchange operators assert that selling virtual securities in a game context is neither gambling nor investing.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.¹⁶¹ However, during the same interview, the CEO described the exchange and trading as replicating real life investment activities.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.¹⁶³

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).

¹⁵⁶ Robin Linden, *Wagering in Second Life: New Policy* (July 25, 2007), <http://blog.secondlife.com/2007/07/25/wagering-in-second-life-new-policy/>.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

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, 200), ("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.").

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.").

¹⁶² *Id.*

¹⁶³ Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 377 (2005).

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.*

¹⁶⁵ BRADEN GLETT, STOCK MARKET STRATAGEM: LOSS CONTROL AND PORTFOLIO MANAGEMENT ENHANCEMENT 52 (2003).

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-

son.¹⁷⁷ Consider, for example, Vlada Fine Furniture & Fixtures (VLADA), a virtual furniture company listed on the International Stock Exchange.¹⁷⁸ Vlada issued stock to raise additional capital in order to “[I]aunch an aggressive advertising campaign that will create brand awareness” and to purchase real estate to launch an outlet store.¹⁷⁹ Investing in Vlada stock is a productive activity because Vlada is producing a good, albeit a virtual one.¹⁸⁰ 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.¹⁸¹

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.¹⁸² For example, when Dragon Global Diversified (DGD) dissolved its virtual business, it liquidated and transferred its cash assets to its shareholders.¹⁸³ Liquidity reduces the cost of capital and encourages investors to invest in the financial assets of virtual businesses.¹⁸⁴ When an in-world investor invests in a virtual world business, the investor’s profits are derived from the success of the virtual business.¹⁸⁵ Therefore, investing on the Second Life virtual stock exchanges does not rely on chance to determine a winner.¹⁸⁶

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 regu-

ties are sold in the “primary market.” *Id.* at 375. Financial markets allow investors to trade securities among themselves in the “secondary market.” *Id.*

¹⁷⁷ See *supra* note 37.

¹⁷⁸ Vlada Fine Furniture & Fixtures, *supra* note 53.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ Dragon Global Diversified, <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).

¹⁸² See *supra* notes 87, 116 text accompanying.

¹⁸³ Dragon Global Diversified, *supra* note 181.

¹⁸⁴ See Posting of Maelstrom Baphomet to <http://www.slcapex.com/forums/topic/SLCX/31?page=2> (July 25, 2007, 20:59 EST) (discussing that the virtual exchanges provide liquidity but noting that a virtual company’s ability to mitigate risk could increase liquidity for its stock).

¹⁸⁵ See Posting of Lex Fitzcarraldo to <http://www.slcapex.com/forums/topic/TNW/81> (Aug. 1, 2007, 23:26 EST) (indicating that “the dividend will encompass 100% of the profits from all TNW business ventures and all TNW incomes”).

¹⁸⁶ Linden, *supra* note 156.

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.¹⁸⁷ 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.¹⁸⁸ 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 territories¹⁸⁹ and would not be available to virtual world issuers.¹⁹⁰ 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.¹⁹¹

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,¹⁹² whereas the amount raised in virtual world public offerings is significantly less.¹⁹³ 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.

¹⁸⁹ 17 C.F.R. § 230.251(a)(1) (2008). After the 1992 amendments, the exemption became unavailable to individuals seeking to utilize the exemption. BLOOMENTHAL, *supra* note 72, at § 2:1.

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.”).

¹⁹¹ U.S. Securities and Exchange Commission, Frequently Asked Questions, <http://www.sec.gov/info/smallbus/qasbsec.htm#eod6> (last visited Mar. 25, 2008).

¹⁹² JOHN C. COFFEE, JR. ET AL., *SECURITIES REGULATION* 168-169 (West Group 2007).

¹⁹³ Benjamin Duranske, *Commentary: Virtual Law Firm Hired by Virtual Company in “IPO” Stage, VIRTUALLY BLIND*, Jan 6, 2008, <http://virtuallyblind.com/2008/01/05/virtual-firm-hired/> [hereinafter *Virtual Law Firm*] (discussing the small amount that one virtual world issuer raised in an IPO).

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).

¹⁹⁸ U.S. Securities and Exchange Commission, *supra* note 191.

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.²⁰² 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.²⁰³ Virtual worlds have developing cultures and social institutions that are increasingly viewed as beneficial to society.²⁰⁴ 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.²⁰⁵ Researchers are interested in new business models and practices that arise from the unique nature of virtual world businesses.²⁰⁶

Researchers have found that Second Life can be a valuable research platform or test tube.²⁰⁷ Virtual worlds provide unique methods for study because they allow researchers to control the environment in which individuals interact and make decisions.²⁰⁸ Research has further found that the virtual world environment can simulate most of the necessary features of a physical laboratory at much lower costs.²⁰⁹ Market research has also become increasingly popular in the virtual world, and marketers are currently testing advertising campaigns, product packaging, and consumer satisfaction.²¹⁰ 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.²¹¹

²⁰² Thomas Chesney et al., *Virtual World Experimentation: An Exploratory Study* (December 9, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1068225.

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.²¹² 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.²¹³ Second Life residents have also established a virtual world Better Business Bureau.²¹⁴ While current self-regulatory measures are far from perfect or impartial,²¹⁵ there is evidence the market is adapting quickly and may continue to organically protect against fraud.²¹⁶ 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.²¹⁷

²¹² Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 781 (2001).

²¹³ Swan *supra* note 61; see also Richard Bloomfield, *What in the World is a Fictional Securities Exchange?*, TERRANOVA, June 29, 2007, http://terranova.blogs.com/terra_nova/2007/06/what-in-the-wor.html (describing the Second Life Exchange Commission as "a group of SL residents seeking to develop stricter listing standards and other practices").

²¹⁴ Nick Wilson, *Inside Second Life's Better Business Bureau*, METAVERSED, June 1, 2007, <http://metaversed.com/01-jun-2007/inside-second-lifes-better-business-bureau>.

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-settlement-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").

²¹⁶ See Cory Ondrejka, *Collapsing Geography: Second Life, Innovation, and the Future of National Power*, 2 *Innovations: Technology, Governance, Globalization*, Summer 2007, at 27, 32. ("Entrepreneurs speak of 'Second Life time', the idea that everything is accelerated within the digital world. . . . Creating and collaborating in a virtual world, with reduced learning costs, low friction micro-transactions, and no marginal cost of reproduction must generate impressive innovation and rates of change.").

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.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.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.²²⁰

eBay successfully built trust among buyers and sellers by developing a reputation system that compiles data from numerous transactions.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.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.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.²²⁴ Starting in 1933,

²¹⁸ Ondrejka, *supra* note 216, at 38-39.

²¹⁹ *Id.* at 39.

²²⁰ *Id.*

²²¹ *Id.*

²²² *Id.*

²²³ Paul Resnick, *Trust Among Strangers in Internet Transactions: Empirical Analysis of eBay's Reputation System* 3 (2002), available at <http://www.si.umich.edu/~presnick/papers/ebayNBER/RZNERBodegaBay.pdf>.

²²⁴ Ondrejka *supra* 216, at 39 ("It is a powerful realization that if an online transaction results in an unsatisfactory experience that the risk falls on the credit card company or seller rather than the consumer.").

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

²²⁵ FDIC, Federal Deposit Insurance Corporation, Insuring Your Deposits, <http://www.fdic.gov/deposit/deposits/insuringdeposits/> (last visited Sept. 22, 2008). Certain retirement accounts are FDIC-insured for up to \$250,000. *Id.*

²²⁶ *Stopping the Panic*, Wall Street Journal, Sept. 20, 2008, http://online.wsj.com/article/SB122186424594658611.html?mod=googlenews_wsj.

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.

