



## Make Sure Your Virtual Currency Doesn't Enter Illegal Gambling Territory

*Just because you don't enable cash-outs doesn't mean your virtual currency is compliant with gambling statutes.*

### VIEWPOINT



By James Gatto

The use of creative business models involving contests, sweepstakes and gambling-like activities in social games and other online media has increased dramatically. These “gamblification” strategies aim for a balance between capitalizing on users’ excitement for the mechanics inherent in gambling while not crossing the line into illegal activity. Often this is done by not permitting a “cash-out” of the virtual currency. But in some cases, the use of virtual currencies and virtual goods is more complex and causes confusion and misconceptions regarding legality. Social game and mobile app developers and others in the social media industry are seeking to cash in on these powerful business opportunities. Companies in the gambling industry are focused on these opportunities as well.

In January 2012, gambling equipment maker IGT bought Facebook casino games developer Double-Down for \$500 million. The \$25 billion online gambling and social media worlds are colliding. However, with the magnitude of activity in this space reaching into the billions of dollars, regulatory scrutiny is starting to increase. For example, Japan’s Consumer Affairs Agency gave notice to a number of game companies that a popular social game technique known as “Kompu Gacha” would no longer be allowed. (Kompu Gacha offers players a valuable grand prize for completing a set of “gacha” prizes, which are awarded randomly, making it difficult to qualify for the big prize.) Certain Japanese game companies, such as Gree, saw about a 25 percent reduction in market cap as a result.<sup>2</sup>

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**Gamblification describes the intersection of social media and gambling, playing on the concept behind “gamification.” As gamification involves the use of game mechanics for nongame purposes, gamblification uses gambling mechanics for non-gambling purposes.**

In the United States, the slowly evolving legal jurisprudence in this area is lagging behind the rapidly advancing use of gamblification. A recent U.S. Department of Justice (DOJ) decision, however, has paved the way for states to permit most forms of online gambling (but not sports betting). This has led to a frenzy of state legislative activity, with some states (e.g., Nevada, California and New Jersey) seeking to permit and others (e.g., Utah) expressly trying to prohibit various forms of online gambling.

Companies need to be aware of the complex legal issues and significant risks involved when gamblification techniques aren't crafted and implemented properly. Criminal penalties exist for unlawful online gambling activities, as shown by 2011 federal indictments against illegal online poker sites operating in the United States. Some payment processors were caught up in the scandal, which involved using what appeared to be legitimate e-commerce transactions but were actually purchases of online poker chips.<sup>3</sup>

### What Is Gamblification?

Businesses are employing a wide range of contests, sweepstakes and gambling-like techniques to attract users and monetize applications. Examples include:

- ➔ **Casino-Like Social Games:** Zynga Poker, one of Zynga's most profitable social games, lets users buy virtual poker chips (but not redeem them) to play an online poker game.

Zynga offers Slingo (a cross between slots and bingo) and Zynga Slots.

- ➔ **Mini-Games:** Some social networking games incorporate mini-games in which, through skill and/or chance, players may obtain in-game items, such as virtual goods, power-ups, virtual currency, etc. Some of these involve spinning a wheel or other random activity but are legal because they only provide virtual goods usable in-game.
- ➔ **Player-to-Player Wagering Platforms:** Virgin Games and others provide platforms to enable gamers to wager against each other on the outcome of game play.
- ➔ **Tournaments:** Many companies host gaming tournaments in which users pay a fee, in real or virtual currency, to compete and win prizes.
- ➔ **Virtual Currency Sweepstakes:** Some sites reward certain user activity with a form of virtual currency that

can be used to enter contests or sweepstakes to win virtual or real goods.

- ➔ **Marketing & Customer Acquisition:** Sites like Cash Dazzle offer users a spin of a prize wheel in exchange for participating in sponsors' offers.
- ➔ **Fantasy Sports Leagues:** Many fantasy sports platforms run the duration of a sports season. Some more recent offerings are based on single games or even single plays, coming close to the line of sports betting, but avoid crossing it by using virtual currency models that don't offer cash out.

### Select Legal Issues Overview

**State Law:** For the most part, the activities above involve two major legal issues, legality and compliance. Whether an activity is legal is largely governed by states. In some cases, laws address contests, sweepstakes and lotteries. Not all illegal lotteries are gambling; some states have specific anti-gambling laws.

Many of these laws were written long before the rise of the Internet,

much less the proliferation of social games and virtual currency. There is a dearth of legal precedent. Some state attorneys general opinions exist, but a few of the AGs have flip-flopped on their positions. Some states now are crafting specific legislation to address online gambling.

**Federal Law:** Until a recent DOJ memo, the Wire Act was interpreted to prohibit states from enacting certain legislation involving online gambling (despite a federal court opinion to the contrary). Now the Wire Act is interpreted as primarily prohibiting sports betting. Other federal statutes facilitate enforcement against activities that violate state gambling and illegal lottery laws. Federal agencies with jurisdiction include DOJ, the U.S. Postal Service, Federal Communications Commission and Federal Trade Commission. (See sidebar on page 103.)

The disparity in state laws makes determining legality and ensuring compliance complex. Many state laws include similar terms to define gambling activities, such as “prize,” “chance” and “consideration,” but the meaning of and test for these terms can vary widely by state (and under federal law). Assuming an activity is legal, compliance requirements differ by state.

### What the States Say

**Elements of Gambling:** Most states regulate these activities by prohibiting illegal lotteries. In states where lotteries are legal, they typically authorize state-run lotteries but prohibit private-sector lotteries. In most states, an illegal lottery or gambling involves three elements:

1. Payment of some form of consideration by user
2. Result determined by chance

### 3. Award/prize, something of value

In general, if all three elements are present, that offering may be an illegal lottery and may be considered gambling. If any of these elements is removed, the offering will generally fall outside the anti-lottery/gambling laws. If payment of consideration is eliminated, the result is typically a sweepstakes. If chance is eliminated, the activity can be a lawful skill-based contest. While these three elements seem to be fairly simple definitions, interpretation is not.

Their meaning varies from state to state, as detailed below, and under federal law. Not all illegal lotteries constitute illegal gambling. Gambling typically involves making a wager or a bet. For certain purposes, Congress has defined “bet or wager” to include staking or risking something of value upon the outcome of a contest of others, a sporting event or a game subject to chance, upon an agreement or understanding that the person or another person will receive something of value based on a certain outcome. Congress excluded the following from this definition:

*“participation in any game or contest in which participants do not stake or risk anything of value other than (i) personal efforts of the participants in playing the game or contest or obtaining access to the Internet; or (ii) points or credits that the sponsor of the game or contest provides to participants free of charge and that can be used or redeemed only for participation in games or contests offered by the sponsor.”*

The points or credits may cover various forms of virtual currency.

In a traditional scenario, consideration would involve a user paying

money to participate in an activity (e.g., a raffle) and receiving a chance (e.g., random drawing) to win a cash prize or valuable tangible goods (e.g., a car). In this situation it’s easy to see that consideration and chance are present and that there is a prize or award of real value. But when virtual goods or currencies are used, determining if there is a payment or prize can be more complex. A challenge for many is the lack of a detailed understanding of virtual goods and virtual currency business models. Some categorically think that because they are virtual, these items never have value. When using contests, sweepstakes and other gamblification techniques in social games and online media, a thorough understanding of legal and regulatory issues of virtual goods and currency is critical.<sup>4</sup>

### Defining the Terms

**Consideration:** This usually means a player must pay something of “value” to be eligible to participate. A payment of cash for the activity itself most always will constitute consideration. However, if a player pays to acquire something of value and also gets a chance to win something, particularly if there is an alternative means of entry that doesn’t require purchase, then this cash “payment” may not be deemed to be consideration. But many states take a much broader view of what constitutes payment of value. In some cases, states have found that consideration may exist if participants are required to expend substantial time or effort to participate.

Under federal law, Congress has expressly excluded payments for Internet access and certain types of virtual currency from the scope of consideration in connection with certain federal gambling regulation.

**Chance:** The meaning of this element varies widely. In some states this element is satisfied if the outcome is determined by any element of chance. In other states, the test involves whether chance or skill predominates. This is perhaps one of the most complex elements to assess. Some legislators and regulators view poker as a game of chance. Professional poker players vehemently disagree. Courts sometimes consider other factors, such as whether the activity involves playing one hand of poker or a longer duration of play (e.g., a multitable tournament). Massively multiplayer online (MMO) and video game players would argue that their play requires skill. But some mini-games or individual game features may involve chance. If a user purchases an in-game weapon that may give the user a better “chance” to accomplish a goal (e.g., slay an in-game monster) and gain more virtual currency or other virtual goods as a result, is that “chance” under the various state laws or is it just part of game play?

**Prize or Award:** This means something of value that a player wins. Prizes can include money and valuable physical goods (e.g., a car or iPad), but can also include something else of value. In one case involving the NCAA lottery system for awarding tickets to Final Four games, winning through the lottery, a right to buy a set of tickets, was not deemed to be a prize. Few cases address this issue.

**The Impact of Virtual Items on the Legal Analysis:** The increasing use of virtual goods and currency in social games and other online gamblification scenarios makes these determinations more difficult. For example, if an online game player puts up virtual currency for

a chance to win virtual goods, has he paid consideration and/or received value? The answer may depend, in part, on whether the virtual currency/goods have “value.” This is a seemingly simple inquiry, but in reality the answer is not always simple. The analysis may depend on:

- ➔ How the player acquired the virtual currency (e.g., whether it was paid for with real cash or earned through game play);
- ➔ What he can do with the virtual currency (e.g., cash it out for real money or physical goods or just use it in a game to acquire virtual goods, which themselves may or may not have extrinsic value); and
- ➔ With whom can it be used (e.g., the virtual currency issuer or third parties).

Some social games and apps include “dual-currency” models, which permit buying one form of virtual currency that may be used only for certain transactions, but earning another form of virtual currency for other transactions. Further complicating the analysis can be the use of dual-currency models and/or whether secondary markets exist for the virtual items. In their terms of service, most social games and social media applications prohibit players from selling or trading virtual goods, virtual currencies or player accounts. Nonetheless, a number of unauthorized secondary markets enable players to do so. To the extent these markets exist and involve real money purchases, this may be relevant to the determination of whether the virtual goods or currency have value. However, in at least one case, a court found that the existence of a secondary market did not mean a “prize” had value.



## Regulatory Compliance

Even if an activity is permissible, online gambling within a specific state, various licensing and other compliance steps still may be necessary. The thrust of many compliance provisions is to ensure winners receive their prizes, protect against defrauding consumers through rigged gambling and prevent money laundering and other financial crimes. Assuming an activity doesn’t constitute illegal gambling, certain compliance issues may still apply. For example, if an activity is a skill-based contest or sweepstakes, some states may require registration of the contest, filing a bond to cover any prize amount, specific written and posted contest or promotion rules and maintenance of records of winners, among other things.

## Other Legal Issues

### ➔ Social Platforms and App

**Stores:** As social networking sites and app stores become the delivery method of choice for social games and apps, companies must develop their gamblification strategies with these platforms in mind. Some of these services preclude certain gambling-related activities. Ensuring conformity with these distribution models from the outset can save time, effort and money.

➔ **Intellectual Property:** New business models and technologies are created by pioneers and innovators. Then they’re copied. In developing

## POTENTIALLY RELEVANT FEDERAL LAWS

The 1961 Wire Act has applicability to online gambling by prohibiting use of most interstate telecommunications media for transmitting bets or wagers, or information assisting in placing bets or wagers on any sporting event or contest. It had been interpreted to prohibit all forms of gambling across state lines or the transfer of gambling-related funds between states or in and out of the country. However, in December 2011, the Department of Justice issued a memo that declared the scope of the Wire Act is limited to sports betting.



**The Unlawful Internet Gambling Enforcement Act (UIGEA):** Enacted in 2006, this is primarily an enforcement statute. It forbids financial institutions from processing payments associated with gambling sites, but excludes

certain activities relating to online lotteries, fantasy sports and horse racing. Section 5363 contains criminal prohibitions and provides that no person engaged in the business of betting or wagering may knowingly accept most payments, including credit, the proceeds of credit, credit card payments, electronic fund transfers or the proceeds from EFTs, checks, drafts or similar instruments, or the proceeds from any other financial transaction from a player in connection with unlawful Internet gambling. The act itself does not precisely define what constitutes unlawful Internet gambling, but instead generally refers to activities that are deemed illegal gambling under federal or state law. Online and mobile payment processors need to ensure that they are not unwittingly processing unlawful transactions.

**The Professional & Amateur Sports Protection Act** makes it unlawful for: (1) a government entity to sponsor, operate, advertise, promote, license or authorize by law or compact, or (2) a person to sponsor, operate, advertise or promote, pursuant to the law or compact of a governmental entity, a lottery, sweepstakes or other betting, gambling or wagering scheme based, directly or indirectly (through the use of geographical references or otherwise), on one or more competitive games in which amateur or professional athletes participate, or are intended to participate, or on one or more performances of such athletes in such games. Because some states (Nevada, Oregon, Delaware and Montana) already had state-authorized sports wagering, statutory exceptions allow them to continue.

industries, intellectual property issues are highly relevant. Many companies, however, don't fully understand or have misconceptions about these issues. Working with IP counsel that


understands virtual currency and gamblification is a must.<sup>5</sup>

→ **Terms of Use:** Many social game companies are aware of the importance of

well-crafted terms of use. Additional considerations are relevant when using gamblification, particularly when virtual goods or virtual currency are involved.

→ **Policing Secondary Markets:** To the extent secondary markets may affect whether a particular gamblification implementation using virtual items involves "value," understanding when and how to police and take action against these markets may be important.

### Conclusion

Opportunities abound to leverage many new, increasing and lucrative business models involving virtual currency and gamblification. However, as the regulatory environment evolves, it is important to understand how best to minimize risk associated with these activities. Consultation with knowledgeable counsel is a must in this area. 

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### ENDNOTES

- 1 Gamblification describes the intersection of social media and gambling, playing on the concept behind "gamification." As gamification involves the use of game mechanics for nongame purposes, gamblification uses gambling mechanics for non-gambling purposes.
- 2 <http://calvinayre.com/2012/05/09/business/japanese-social-game-firms-fear-gacha-crackdown/>
- 3 [www.forbes.com/sites/nathanvardi/2011/11/22/indicted-banker-and-payment-processor-fight-federal-crackdown-on-online-poker-with-powerful-legal-papers/](http://www.forbes.com/sites/nathanvardi/2011/11/22/indicted-banker-and-payment-processor-fight-federal-crackdown-on-online-poker-with-powerful-legal-papers/)
- 4 See our blog [www.virtualworldlaw.com](http://www.virtualworldlaw.com).
- 5 See our advisory "IP Protection for Games" [www.pillsburylaw.com/siteFiles/Publications/IPProtectionforGamesBrochure2011.pdf](http://www.pillsburylaw.com/siteFiles/Publications/IPProtectionforGamesBrochure2011.pdf).