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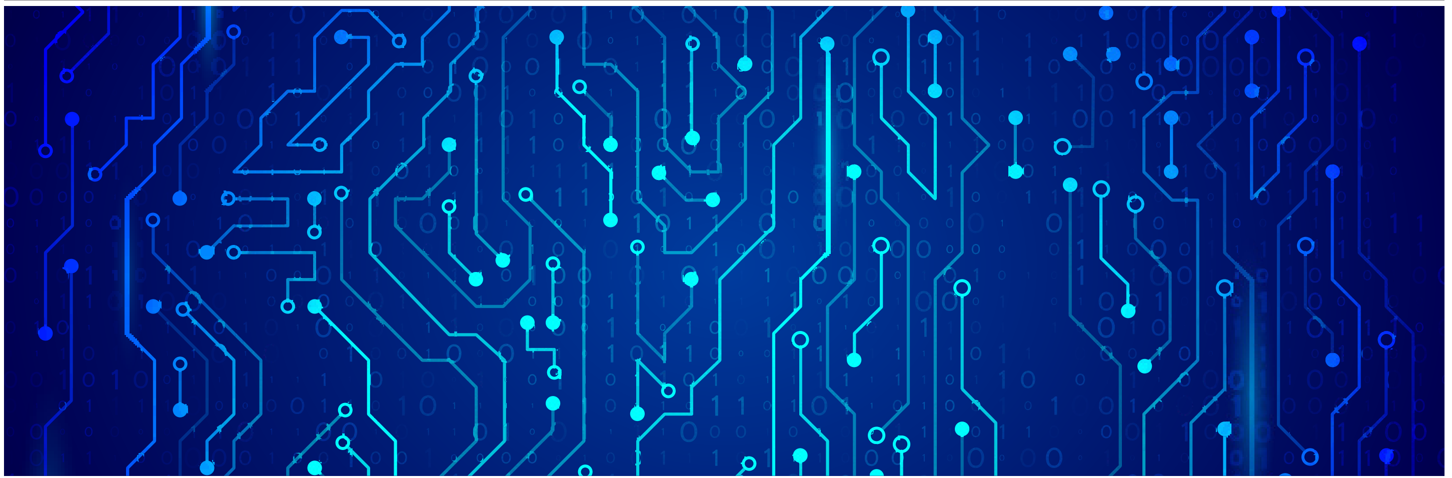

# Legal Issues With Blockchain-Based Crypto Games and Collectibles

The use of blockchain technology for crypto games and token-based digital collectibles is on the rise. One of the first crypto games of note was CryptoKitties. It may turn out that CryptoKitties becomes to crypto games what Pokémon Go was to location-based AR games. Both became huge successes overnight and raised awareness of the opportunities for their respective genres of games. CryptoKitties, which recently raised $12 million, involves crypto games and digital collectibles. Many other crypto games and collectibles have followed. So, too, have crypto goods marketplaces, such as Rarebits, which recently raised $6 million. These offerings have tremendous potential. But, as always, these new opportunities raise potential legal issues.

Much of the regulatory activity in the crypto space has focused on Initial Coin Offerings (ICOs). Little attention has been paid to the legal issues surrounding crypto games and collectibles. As explained below, some of the securities laws issues related to ICOs may be relevant to certain implementations in the crypto games and collectibles space. Many companies have launched ICOs without complying with the regulatory requirements. The SEC has recently issued subpoenas to many companies that launched ICOs. It remains to be seen what will happen with these companies. Ripple, one of the highest market cap digital currencies, has been sued for allegedly selling XRP as an unregistered security, in "what is essentially a never-ending initial coin offering." Various other legal issues may also be relevant.

Tremendous opportunities exist to leverage blockchain technology for interactive entertainment applications, including crypto games and crypto collectibles. However, for companies entering this space, it is critical to get a legal assessment of your business model and your specific implementation to mitigate legal issues.

The following is an overview of some of the legal issues that can arise in these areas. This is not a comprehensive list. Each offering needs to be evaluated based on its specific facts and the relevant law.

1. **Tokens as Securities** – if not structured properly, some tokenized assets (e.g., virtual items in crypto games and crypto collectibles) could run afoul of securities laws. Many companies are offering "digital collectibles" using an ERC-721 crypto token, where the token represents ownership of the item. Some of these companies also are providing a marketplace for users to buy, trade and sell the tokens. In some cases, the digital collectibles' value can be enhanced through various interactions with the platform.

The Securities and Exchange Commission (SEC) has issued guidance on and made determinations that the issuance of certain crypto tokens are securities and must comply with the securities laws.

One of the key components of the securities laws the SEC has focused on is the term "investment contracts," as defined by the Howey Test. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). Under this test a transaction is an investment contract, and thus a security, if: a) it is an **investment of money**; 2) in a **common enterprise**; 3) there is a **reasonable expectation of profits** from the **investment; and 4) the profits are to be derived from the** entrepreneurial or managerial efforts of others.

If users pay money for digital items based on an expectation of profit and the expectation of profits is arguably derived from the managerial efforts of others (e.g., the token platform operator), the token could be found to be a security.

2. **Token Marketplaces as Security Exchanges** – if token marketplaces permit sale of tokens that meet the test for a security, they might be deemed a security exchange The SEC recently issued guidance on platforms that permit users to buy and sell digital assets, including digital coins and tokens. According to the SEC, a number of these platforms provide a mechanism for trading assets that meet the definition of a "security" under the federal securities laws. If a platform offers trading of digital assets that are securities and operates as an "exchange," as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration. One example of a game-based cryptocurrency is Enjin Coin, a customizable cryptocurrency and virtual goods platform for gaming.

   It is possible under certain circumstances that a token marketplace, which enables users to buy, sell and trade tokenized assets, could be deemed a securities exchange, if the underlying tokens are deemed a security.

3. **Gambling** – if not structured properly, some crypto games and collectibles could run afoul of gambling laws. A number of recent gambling cases against traditional (non-crypto) social game companies were dismissed because the virtual items at stake were found to not be "something of value."

   Although state gambling laws vary, under some states' laws, the test for gambling is stated as: "[1] staking or risking something of value [2] upon the outcome of a contest of chance or a future contingent event not under the person's control or influence, [3] upon an agreement or understanding that the person or someone else will receive something of value in the event of a certain outcome."

   As we have previously addressed, in many of these cases, the social games company successfully argued that their game did not involve gambling for a number of reasons. A common argument was that the virtual items won were not a thing of value. The courts have historically agreed with this, where the game's terms of service prohibited the transfer of the virtual items and the game publisher did not host or sanction these secondary markets. In these cases, the courts typically have acknowledged the existence of unauthorized secondary markets for trading virtual items, but did not attribute those activities to the game publisher.

   In contrast, many crypto games and digital collectibles platforms do provide a marketplace to buy, sell and trade the items. The existence of a marketplace, alone, does not mean there is gambling, but combined with other facts, it may contribute to such a finding. For example, if a game enables a user to stake something of value for a chance to win virtual items that can be sold in an open marketplace offered by the publisher, a gambling analysis would need to be performed. Similarly, such an analysis would be needed if a user could stake or risk such virtual items for a chance to win something else of value. It may be that these types of mechanic could be implemented without running afoul of gambling laws, but careful consideration is advised.

4. **Money Transmitters –** Certain activities associated with "convertible" digital currency may be subject to the Bank Secrecy Act ("BSA") and money transmitter laws. In its initial interpretive guidance on virtual currencies, the Financial Crimes Enforcement Network ("FinCEN"), addressed convertible virtual currency, which it indicated either has an equivalent value in real currency or acts as a substitute for real currency.

   It further addressed various scenarios and use cases and the applicability of the regulations implementing the Bank Secrecy Act ("BSA") to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies. FinCEN stated that the definition of a money transmitter does not differentiate between real currencies and convertible virtual currencies. Accepting and transmitting anything of value that substitutes for currency may make a person a money transmitter under the regulations implementing the BSA.

   FinCEN *defined* an exchanger as a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency and an administrator as a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.

   According to the guidance, an administrator or exchanger that (1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter under FinCEN's regulations, unless a limitation to or exemption from the definition applies to the person. FinCEN's regulations define the term "money transmitter" as a person that provides money transmission services, or any other person engaged in the transfer of funds. The term "money transmission services" means "the acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means."

   Many companies in the game industry took comfort with this guidance because most in-game currency cannot be "cashed out", and thus was not likely a convertible virtual currency and not subject to these issues. In contrast, if a crypto game company uses tokens that are deemed a convertible virtual currency, these provisions may be applicable.

   For entities that operate marketplaces, it is important to analyze whether their proposed activities fall within the scope of this guidance and, if so, to ensure compliance or that an exemption applies.

5. **Blockchain-based Virtual Worlds May Face Similar Issues** – A number of blockchain-based virtual worlds have been launched. Decentraland, which raised $26 million via an ICO, is an example. According to its whitepaper, Decentraland users can purchase parcels of land and other digital assets using MANA tokens. Users can also create, experience, and monetize content and applications. Over time, there have a number of legal issues with "traditional" virtual worlds. All of these issues should be considered with blockchain based virtual worlds, plus the issues addressed above.

6. **Don't Forget to Consider Patents** – As with other aspects of blockchain-based applications, the number of patents being filed is increasing. As one example, Tap Project, has applied for a patent on a method that allows gamers to convert their in-game currencies into cryptocurrencies.

   There are many misconceptions around the patenting of games, in general. We see even more confusion when it comes to the patentability of crypto games. We have recently prepared a paper on patenting blockchain-based technology. Collectively, these papers provide a good primer on some of the key issues. If you think you have a patentable invention in this area, a consultation with a knowledgeable patent attorney is strongly recommended.

### Conclusion

Blockchain-based crypto games and collectibles have tremendous potential for growth, but also present some legal risks. With knowledge of the relevant issues and careful structuring, many legal pitfalls should be avoidable.

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Mr. Gatto leads Sheppard Mullin's Blockchain Technology and Digital Currency Team and Co-heads its Social Media and Games Team. He has been a pioneer on legal issues with digital currency for over a decade and offers a rare breadth of legal expertise covering patents, securities and regulatory issues, gambling and open source issues. He has advised many game companies on patent and regulatory issues with their digital currency systems and advises numerous companies in the blockchain and digital currency space.

Sheppard Mullin's Blockchain Technology and Digital Currency Team helps clients develop innovative and comprehensive legal strategies to take advantage of what may be the most disruptive and transformative technology since the internet. We focus on advising clients on how to meet their business objectives, without incurring unnecessary legal risk. Our team includes attorneys with diverse legal backgrounds who collectively understand the vast array of legal issues with and ramifications of blockchain technology and digital currencies.