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SEC Issues Investor Alert Warning That Fantasy Stock Trading Websites May Violate Securities Laws

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

At the end of June, the SEC Office of Investor Education and Advocacy issued an Investor Alert and reminded us all that the net of federal securities laws is far-reaching. The Investor Alert warns investors that fantasy stock trading and similar websites violate federal securities laws and, in particular, the "security-based swap" regulations enacted by the Dodd-Frank Act.

The SEC Investor Alert warns against websites that claim to offer a chance to make money from publicly traded or privately held companies without actually buying stock. Generally the sites are set up as a "fantasy" trading game or competition and involve a small entry fee with the chance to win a larger payment if you win the fantasy competition. The SEC has taken the position that these fantasy stock trading programs could potentially involve security-based swaps and implicate both the federal securities and commodities laws. The SEC has and is continuing to investigate the matter. The investigation has progressed enough that the SEC found it prudent to issue the Investor Alert.

Security-based Swaps

Like the definition of a security itself, a "security-based swap" is broadly defined. A "swap" is a financial contract in which two or more counterparties agree to exchange or "swap" payments with each other as a result of such things as changes in stock price, interest rate or commodity price. In other words, a swap includes any agreement, contract, or transaction whose value is based upon the value or performance of some other financial product, event or characteristic.

Generally, practitioners and the marketplace consider a security-based swap to be a derivative or other complicated financial instrument that only the most sophisticated institutional investors and brokerage houses participate in. For the most part, that is entirely true and correct. The national exchanges do not provide a trading platform for security-based swaps. Rather, a whole trading regime and marketplace has been established around the multi-trillion-dollar swaps market, including security-based swap execution facilities, security-based swap data repositories, security-based swap clearing agencies and a swap-based over-the-counter market. This is not to be confused with the OTC Marketplace for equity securities, which is a distinct and separate marketplace for the trading of unlisted securities (i.e., OTC Pink, OTCQB and OTCQX).

Historically, security-based swaps were not addressed in federal regulations. In 2000, Congress actually specifically removed security-based swaps from the SEC's jurisdiction. In particular, in 2000, Congress passed the Commodity Futures Modernization Act (CFMA) to provide legal certainty for swap agreements. The CFMA explicitly prohibited the SEC and CFTC from regulating the over-the-counter swaps markets, but provided the SEC with antifraud authority over "security-based swap agreements," such as credit default swaps. By preventing specific anti-fraud regulation but allowing anti-fraud jurisdictional authority, the CFMA tied the SEC's hands and created an unworkable regulatory framework.

The Dodd-Frank Act addressed the gap and provided a broad, comprehensive regulatory framework for the OTC swaps market. The Dodd-Frank Act divided regulatory authority over swap agreements between the SEC and CFTC as well as other regulators such as the Federal Reserve Board related to banking swap entities. The SEC's authority is over "security-based swaps." Security-based swaps are included within the definition of "security" under the Securities Exchange Act of 1934 and the Securities Act of 1933. The CFTC has primary authority over commodity-based swaps, and the SEC and CFTC share authority over mixed swaps.

Implementation of the Dodd-Frank Act related to swaps has required numerous rules and a prolific volume of complicated rule releases. The CFTC and SEC are required to act jointly to define key terms relating to jurisdiction (such as swap, security-based swap, and security-based swap agreement) and market intermediaries (such as swap and security-based swap dealers and major swap and security-based swap participants), as well as adopt joint regulations regarding mixed swaps and prescribe trade repository recordkeeping requirements, and books and records requirements for swap entities related to security-based swap agreements. The SEC is required to consult with the CFTC and the Federal Reserve Board on non-joint rulemakings and with the other prudential regulators on capital and margin rules. The CFTC, SEC and U.S. regulators also consult with non-U.S. regulatory authorities on the establishment of consistent international standards for the international swaps market.

My practice and clientele usually do not require me to delve into the rules, regulations and practical operations of swaps in general or even the more defined security-based swaps. However, this new Investor Alert directed towards the same average investor that trades in the OTC Marketplace and national securities exchanges caught my attention and is worth a discussion.

Fantasy Stock Trading

The SEC anti-fraud provisions apply to all transactions in security-based swaps regardless of the sophistication or wealth of the investors. Initially it is helpful to know a few terms. First, an investor or participant in the swaps market is called a "counterparty" or "counterparties." Second, an "eligible contract participant" or "ECP" is specifically defined in the securities laws (much like an "accredited investor") and includes, for example, people who have more than $10 million invested on a discretionary basis. The federal securities laws contain many provisions related to the offer or sale of security-based swaps to persons who are not eligible contract participants. A registration statement must be filed and effective prior to offering a swap to a non-ECP, and the swap contracts must be sold on a national exchange.

The SEC notes that there are many different ways that virtual games references securities involve a security-based swap. For example, the SEC believes a security based-swap would encompass a website could charge an entry fee to play a game involving the "purchase" or "sale" of securities and the ability to win a prize for such efforts. As with other fantasy games, no actual particular company's securities would be purchased or sold. Each site and fact scenario requires a review and analysis as to whether it involves a security-based swap, has invoked the federal securities laws, and has complied with such laws.

Taking the position that a fantasy stock trading website could be a security-based swap, the operation of the site and offer to the public to participate requires an analysis as to whether the persons receiving the offer are eligible contract participants and if they are not, ensuring the proper disclosures and rules related to offers to non-eligible contract participants are complied with. I am certain that none of the operators of these sites have made such an analysis or complied with the applicable federal securities laws.

The SEC recently filed and settled an action In the Matter of Sand Hill Exchange. Garrit Hall and Elaine Ou, in which the SEC issued a cease-and-desist order against a website operator and its principals. The particular site claimed to offer anyone an opportunity to realize profits based on the performance of private pre-IPO companies. The website offered to sell "contracts" referencing the pre-IPO company. If the pre-IPO company had a liquidity event, such as an IPO, merger or acquisition, the contract buyer would receive payment on the contract based on a value calculation. The SEC found that the contracts were firmly within the definition of a security-based swap and shut down the site.

Other Warnings

The SEC Investor Alert also reminds the public that the federal securities laws are in addition to and separate from other federal laws, such as the federal gambling laws. A website may be operating in compliance with the Unlawful Internet Gambling Enforcement Act of 2006 and still be violating federal securities laws.

Moreover, the SEC stresses that consideration or payment can be in any form, not just cash. The payment to a website or third party in bitcoins, virtual currency, traded goods or services, or anything of value, invokes the securities laws to the exact same extent as the payment in cash.

Conclusion

The purpose of the SEC Investor Alert is to warn the general public against these websites and really any website that requires payment to “play” or participate in a game or other “investment” that may not appear to be a security on its face. From my perspective, the Investor Alert is a reminder to all entrepreneurs that the federal securities laws are all-encompassing and must be considered in any and all business models. For additional information regarding the definition of a security, please see my blog HERE.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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