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The Risk of Regulatory Arbitrage: A Response to *Securities Regulation in Virtual Space*

Wendy Gerwick Couture*

Abstract

In Securities Regulation in Virtual Space, Eric. C. Chaffee explores the potential applicability of the securities laws to virtual transactions based on virtual activity and argues that, although many of these transactions likely qualify as "investment contracts" under S.E.C. v. W.J. Howey Co., they should be excluded under the context clause because, among other reasons, application of the securities laws would stifle creativity within this innovative space. This Response proposes a reframing of the Howey test as a response to the risk of regulatory arbitrage, argues that the context clause should only exclude transactions that do not pose such a risk, contends that transactions in virtual space do pose a risk of regulatory arbitrage, and thus concludes that these transactions should not be excluded from the securities laws. In recognition of Professor Chaffee's compelling argument that securities regulation would hinder creativity within this burgeoning area, this Response argues for a new exemption from registration that would further the policy goals of the securities laws while not stifling innovation in virtual space.

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I am delighted to have this opportunity to respond briefly to Eric C. Chaffee's thought-provoking article, *Securities Regulation in Virtual Space*.[1] Professor Chaffee's article explores the potential applicability of the securities laws to virtual transactions based on virtual activity and argues that, although many of these transactions likely qualify as "investment contracts" under *S.E.C. v. W.J. Howey Co.*,[2] they should be excluded under the context clause[3] because, among other reasons, application of the securities laws would stifle creativity within this innovative space.

My response proceeds in three parts. In Part I, I discuss four unique contributions that Professor Chaffee's article makes to the extant literature.[4] In Part II, I propose a reframing of the *Howey* test and the context clause as a response to the risk of regulatory arbitrage.[5] I argue that *Howey*'s broad definition of "investment contract" operates to prevent parties from structuring transactions to evade the securities laws and that the context clause operates as a release valve to the extent the transaction at issue does not pose a risk of regulatory arbitrage. In Part III, I apply this new perspective on the intersection of the *Howey* test and the context clause to virtual transactions based on virtual

1. Eric C. Chaffee, *Securities Regulation in Virtual Space*, 74 WASH. & LEE L. REV. 1387 (2017).

2. S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

3. 15 U.S.C. § 77b(a) (prefacing the definitions with the clause "unless the context otherwise requires"); 15 U.S.C. § 78c(a) (same).

4. *See infra* Part I.

5. *See infra* Part II.

activity.[6] I contend that, because these transactions pose a risk of regulatory arbitrage, they should not be excluded by the context clause. Finally, in response to Professor Chaffee's compelling argument that securities regulation would hinder creativity within this burgeoning area, I argue that a better response is to enact a new exemption from registration that would further the policy goals of the securities laws while not stifling innovation in virtual space.[7]

I. Unique Contributions of Securities Regulation in Virtual Space

Professor Chaffee's article makes several unique contributions. First, he creates a new taxonomy for securities transactions: (1) real-world transactions based on real-world activity; (2) real-world transactions based on virtual activity; (3) virtual transactions based on real-world activity; and (4) virtual transactions based on virtual activity.[8] As explained by Professor Chaffee, the potential applicability of securities regulation differs in each context, and I anticipate that future scholars and courts will find this taxonomy useful when analyzing novel transactions.

Second, Professor Chaffee provides the first in-depth discussion of transactions within the fourth category of his taxonomy: virtual transactions based on virtual activity.[9] After providing a primer on video games, virtual worlds, virtual reality, and augmented reality, he gives examples of transactions that already fall within this category, such as securities exchanges that operate in the online virtual world of Second Life, and recognizes the potential future growth of this type of virtual transaction.[10]

Third, Professor Chaffee applies the *Howey* test[11] for "investment contracts,"[12] which are a subset of the securities

6. *See infra* Part III.
7. *See id.*
8. Chaffee, *supra* note 1, at 1419.
9. *Id.* at 1422.
10. *Id.* at 1394–98 & 1422–25.
11. *Howey*, 328 U.S. at 298–99.
12. 15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78c(a)(10).

regulated by the federal securities laws, to virtual transactions based on virtual activity, concluding that many of these transactions likely qualify as investment contracts.[13] He also recognizes that these transactions could be structured to fall outside the scope of the *Howey* test, such as by eliminating the potential for real world currency to be exchanged for virtual currency, but argues that these workarounds the *Howey* test would limit innovation.[14]

Finally, applying an expansive interpretation of the prefatory clause "unless the context otherwise requires,"[15] Professor Chaffee argues that virtual transactions based on virtual activity should be excluded from the definition of "security," despite their likely satisfaction of the *Howey* test.[16] Professor Chaffee contends that the policy reasons for excluding these transactions from the scope of securities regulation outweigh the policy reasons for including them.[17] Professor Chaffee argues that it would exceed Congressional intent to apply the securities laws to transactions without a substantial link to the real world;[18] that extending the reach of the federal securities laws to these transactions, where "doubt exists as to whether Congress has exercised its power" to regulate,[19] would implicate federalism and separation of power concerns;[20] and that applying securities regulation to these transactions would hinder creativity within this burgeoning space.[21]

My response to Professor Chaffee's article focuses on the last of these contributions. In short, I propose a reframing of the *Howey* test and the context clause as a response to the risk of regulatory arbitrage. Drawing therefrom, I argue that, rather than excluding virtual transactions based on virtual activity from securities regulation altogether, these transactions should be

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13. *Chaffee*, supra note 1, at 1423–27.
14. *Id.* at 1427.
15. 15 U.S.C. § 77b(a); 15 U.S.C. § 78c(a).
16. Chaffee, *supra* note 1, at 1433–35.
17. *Id.* at 1435–56.
18. *Id.* at 1435–39.
19. *Id.* at 1440.
20. *Id.* at 1439–44.
21. *Id.* at 1444–48.

subject to a new exemption from registration requirements but not from securities fraud prohibitions.

II. Reframing the Howey *Test and the Context Clause as a Response to the Risk of Regulatory Arbitrage*

I propose a new way of looking at the interaction of the *Howey* test for "investment contracts" and the prefatory context clause: as a response to the risk of regulatory arbitrage.

A. Risk of Regulatory Arbitrage in the Context of Securities

Regulatory arbitrage "exploits the gap between the economic substance of a transaction and its legal or regulatory treatment, taking advantage of the legal system's intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision."[22] As explained by Victor Fleischer, when parties engage in regulatory arbitrage, they may select structures that increase transaction costs but decrease regulatory costs, thus "leading to results that are inefficient in the short run and indeterminate in the long run."[23] Moreover, to the extent that parties engaging in regulatory arbitrage are able to avoid regulation that seeks to further certain policy goals, those policy goals are undercut.

Broadly speaking, securities regulation furthers two general policy goals when applied to transactions: ensuring that investors have sufficient information when making investment decisions and deterring fraud.[24] The requirement that securities offerings either be registered or exempt from registration[25] furthers the

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22. Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 229 (2010).

23. *Id.* at 275.

24. *See* Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of "Security": The "Context" Claus, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 512 (1987) ("The Acts have at least a dual function: to provide an adequate and accurate informational flow to the investing public and to ensure a measure of integrity and protection against abuse in the marketplace.").

25. 15 U.S.C. § 77e.

former purpose, and the securities fraud prohibitions,[26] including private rights of action, further the latter.

Not surprisingly, compliance with the securities laws is costly, which motivates parties to structure transactions in order to avoid application of the securities laws. As a recent example, initial coin offerings, to the extent that they are structured in an attempt to avoid application of the securities laws, demonstrate the incentive for regulatory arbitrage in the context of securities.[27]

B. The Howey *Test as a Broad Rule to Prevent Regulatory Arbitrage*

One way of preventing regulatory arbitrage is to adopt broad rules that are "not targeted at a specific deal structure or type of investment," thus limiting the opportunity to structure a transaction in a way to avoid regulatory coverage.[28] As an example of such a broad rule, Professor Fleischer cites Section 469 of the Tax Code,[29] which "targets all passive-activity losses, however generated" and thus decreases the ability to exploit tax shelters.[30]

The securities laws apply only to transactions in "securities," which are defined with a laundry list that includes specific types of securities like "notes" and "stock."[31] If the list were limited to

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26. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

27. *See* SEC Chairman Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, U.S. SEC. & EXCH. COMM'N (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11#_ftnref5 ("Following the issuance of the 21(a) Report, certain market professionals have attempted to highlight utility characteristics of their proposed initial coin offerings in an effort to claim that their proposed tokens or coins are not securities."); *see also* Securities and Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, S.E.C. Release No. 81207 (July 25, 2017) [hereinafter "The 21(a) Report"] (analyzing whether the sale of particular tokens by a decentralized autonomous organization are within the scope of the securities laws).

28. Fleischer, *supra* note 22, at 255.

29. 26 U.S.C. § 469.

30. Fleischer, *supra* note 22, at 255.

31. 15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78c(a)(10).

these specific types, there would be a significant opportunity to structure transactions to avoid the securities laws. The definition of "security" also includes a catch-all, however—the aforementioned "investment contract."[32] As defined by the Supreme Court in *Howey*, an investment contract is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[33] These elements together represent the types of interests, no matter how structured, that merit regulation under the securities laws.[34] The premise of this definition of "investment contract" is that the policy goals of ensuring disclosure and preventing fraud are implicated when people make investments (contribute money with the goal of profiting) in a pooled transaction in which the investors are largely passive (and thus unable to protect themselves to the same degree as if they were active participants in the venture).[35]

In other words, the broad definition of "investment contract" prevents regulatory arbitrage. Indeed, the Supreme Court in *Howey* emphasized this rationale for defining investment contracts broadly: "It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[36] In addition, this

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32. 15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78c(a)(10).

33. *Howey*, 328 U.S. at 298–99.

34. *See id.* at 298 ("Form was disregarded for substance and emphasis was placed upon economic reality.").

35. *See* Jonathan M. Sobel, *A Rose May Not Always Be A Rose: Some General Partnership Interests Should Be Deemed Securities Under the Federal Securities Acts*, 15 CARDOZO L. REV. 1313, 1316 (1994) ("The *Howey* test attempts to distinguish passive investors from those able to protect their own investments. These latter investors are generally thought not to need the protection of the securities acts.").

36. *Howey*, 328 U.S. at 299; *accord* S.E.C. v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)

> However, the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts, " or as 'any interest or instrument commonly known as a

rationale is consistent with Congress's intent to apply the securities laws to "the many types of instruments that in our commercial world fall within the ordinary concept of a security."[37] For this reason, although I agree with Professor Chaffee that, in 1933 and 1934, Congress did not anticipate that the securities laws would to apply to transactions without a substantial link to the real world,[38] I disagree that Congress did not intend for the securities laws to be responsive to changing technology, including the potential application to virtual transactions based on virtual activity. Likewise, because Congress intended the category of "investment contracts" to operate as a catch-all, I disagree with Professor Chaffee that it implicates federalism or separation of powers concerns for it to do just that.

And the broad definition of "investment contract" has been effective in preventing regulatory arbitrage. As a recent example, the Securities and Exchange Commission interpreted particular tokens sold by a decentralized autonomous organization to be investment contracts and thus subject to the securities laws.[39] As explained by S.E.C. Chair Jay Clayton in a recent public statement, "replacing a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction, but it does not change the substance."[40]

C. The Context Clause as a Release Valve When There Is Not an Arbitrage Risk

And yet, by using a broad rule to prevent regulatory arbitrage, there is also a risk that the rule will bring transactions within the scope of regulation even if they do not pose an arbitrage risk. Therefore, it is helpful to include a release valve

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"security."

37. *Howey*, 328 U.S. at 229 (quoting H. Rep. No. 85, 73rd Cong. 1st Sess., p.11).

38. *See* Chaffee, *supra* note 1, at 1435-39.

39. *See* Securities and Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, S.E.C. Release No. 81207 (July 25, 2017).

40. *Supra* note 27.

that excludes those transactions that do not pose such a risk, lest those transactions be burdened unnecessarily. I argue that the context clause interacts with the definition of "investment contract" in this way. In other words, rather than Professor Chaffee's interpretation of the context clause as an invitation to analyze whether "the surrounding conditions of the thing that might be a security dictate that it not be covered by the federal securities law,"[41] I contend that the context clause should apply only to those situations in which the definition of investment contract reaches too broadly and sweeps in transactions that do not pose a risk of regulatory arbitrage.

As accurately explained by Professor Chaffee, the Supreme Court has not provided explicit guidance about the scope of the context clause.[42] While aspects of the Court's seminal context clause opinion, *Marine Bank v. Weaver*,[43] have been aptly criticized as "the product of hopelessly circular logic"[44] and as "bristl[ing] with analytical deficiencies,"[45] I contend that the Court's application of the context clause in *Weaver* is consistent with its role as a release valve when there is not a risk of regulatory arbitrage.

In *Weaver*, the Court explicitly applied the context clause to exclude a certificate of deposit issued by a federally regulated bank from the scope of the securities laws[46] and implicitly applied it to exclude a unique profit-sharing agreement between two families.[47] Both scenarios are consistent with my conception of using the context clause to exclude transactions that do not pose a risk of regulatory arbitrage.

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41. Chaffee, *supra* note 1, at 1435.

42. *See id.* at 1434 ("[O]ne starts with a relatively blank slate in determining whether the 'unless the context otherwise requires' language excludes securities entirely within virtual space from coverage by federal securities law.").

43. Marine Bank v. Weaver, 455 U.S. 551 (1982).

44. Steinberg & Kaulbach, *supra* note 24, at 521.

45. Gary P. Bunch, *Marine Bank v. Weaver: What is a Security?*, 34 MERCER L. REV. 1017, 1042 (1983).

46. *Weaver*, 455 U.S. at 559.

47. *Id.* at 560; *see* Steinberg & Kaulbach, *supra* note 24, at 507 (recognizing the "Court's implicit application of the 'context' clause to preclude the Weaver profit-sharing agreement").

First, the certificate of deposit did not pose a risk of regulatory arbitrage because it was already "subject to the comprehensive set of regulations governing the banking industry,"[48] which is comparably robust to the regulations governing securities. The reporting, inspection, and advertising rules that apply to federally regulated banks arguably serve as a substitute for the registration and reporting rules that apply to securities,[49] and FDIC insurance arguably serves as a substitute for the securities acts' antifraud rules.[50] Therefore, it is unlikely that transactions would be restructured to take advantage of banking regulation and avoid securities regulation.

This is admittedly a re-framing of the Court's reasoning in *Weaver*, which focused on the specific risk of investor harm[51] rather than the general risk of regulatory arbitrage. But this interpretation of *Weaver* is responsive to the legitimate critique that "FDIC protection is not analogous to the availability of a private right of action under the securities laws: the former insures against loss, but the latter serves as both a deterrent and a remedy in proper circumstances."[52] If *Weaver* is interpreted as an assessment of the risk of regulatory arbitrage, the comparability of the specific antifraud protections afforded investors under the two regulatory schemes is less important than an assessment of the general risk of incentivizing parties to restructure transactions to avoid the securities laws.

Second, the profit-sharing agreement between two families in *Weaver* did not pose a risk of regulatory arbitrage because of its unique nature, which is unlikely to be duplicated by other parties in an effort to evade the securities laws. The agreement at issue was between the Piccirillo family and the Weaver family. The Weavers agreed to guarantee a bank loan to a slaughterhouse and retail meat business owned by the Piccirillos.[53] In return, the

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48. *Weaver*, 455 U.S. at 558.

49. *Id.*; Steinberg & Kaulbach, *supra* note 24, at 514.

50. *Weaver*, 455 U.S. at 558; Steinberg & Kaulbach, *supra* note 24, at 514.

51. *See Weaver*, 455 U.S. at 559 ("It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws.").

52. Steinberg & Kaulbach, *supra* note 24, at 515.

53. *Weaver*, 455 U.S. at 553.

Piccirillos granted the Weavers 50% of the business's net profits, $100 per month, usage of the business's barn and pasture, and the right to veto future borrowing by the business.[54] Because this was a "unique agreement, negotiated one-on-one by the parties,"[55] it did not pose a risk of regulatory arbitrage; indeed, it is unlikely that parties would introduce barn-sharing into their transactions in order to evade the securities laws.

While this is admittedly a re-focusing of the Court's reasoning in *Weaver*, which centered on whether the Piccirollos treated the agreement as a security (such as by distributing a prospectus)[56] rather than on whether it posed the risk of regulatory arbitrage. But this interpretation of *Weaver* is responsive to the legitimate critique that the Court's reasoning is "hopelessly circular": "[I]f a prospectus is required only upon first determining that a security is involved, how can 'security' be defined in terms of whether a prospectus is distributed?"[57] If *Weaver* is interpreted as an assessment of the risk of regulatory arbitrage, the parties' anticipation of the potential applicability of the securities laws is relevant.

Therefore, I argue that the context clause should be interpreted as providing a release valve for transactions that do not pose a risk of regulatory arbitrage. *Weaver* exemplifies two situations in which it is unlikely that parties would adopt certain structures in an effort to evade the securities laws: (1) where another comprehensive regulatory scheme would apply to the transaction even if the securities laws do not; and (2) where the transaction is of such a unique nature that it is unlikely to be duplicated or scaled.

III. The Risk of Regulatory Arbitrage in Virtual Space

Drawing from this conception—that the definition of "investment contract" and the context clause work together to

54. *Id.*

55. *Id.* at 560.

56. *See id.* ("[T]he Piccirillos distributed no prospectus to the Weavers or to other potential investors, and the unique agreement they negotiated was not designed to be traded publicly.").

57. Steinberg & Kaulbach, *supra* note 24, at 521.

reduce the risk of regulatory arbitrage—the question presented by virtual transactions based on virtual reality is whether they pose a risk of regulatory arbitrage. I agree with Professor Chaffee that these transactions likely fall within the broad definition of "investment contract." But, I contend that they should be excluded by the context clause only if they do not pose a risk of regulatory arbitrage.

The risk of regulatory arbitrage is reduced if the transactions are subject to another comprehensive body of law (like federal banking regulations) that, although not mimicking the securities laws, responds to the central securities laws concerns of ensuring disclosure and prohibiting fraud. Although Professor Chaffee notes that criminal wire fraud provisions would likely apply to virtual transactions based on virtual activity,[58] which is responsive to some degree to the antifraud aspect of the securities laws, no other body of law imposes disclosure requirements akin to those imposed by the securities laws. Therefore, the presence of another body of comprehensive regulation does not limit the risk of regulatory arbitrage for these virtual transactions.

The risk of regulatory arbitrage is also reduced if the transactions are unlikely to be viable alternatives to traditional securities (such as a profit-sharing agreement between families that includes access to a barn and pasture). If virtual transactions based on virtual activity were limited to a relatively circumscribed world, perhaps they could be analogized to the profit-sharing agreement in *Weaver*. But, as Professor Chaffee notes, "[v]irtual space existing within video games, virtual worlds, virtual reality, and augmented reality has become a regular part of most peoples' lives."[59] Therefore, I believe that excluding these virtual transactions from the scope of the securities laws poses the risk of funneling transactions to this platform and undercutting the goals of the securities laws.

Therefore, I argue that virtual transactions based on virtual reality, to the extent they fall within the definition of "investment contracts," should be treated as securities. In response to Professor Chaffee's legitimate concern about hindering creativity in this burgeoning area, I believe that the better response is to

58. Chaffee, *supra* note 1, at 1452.
59. *Id.* at 1455.

enact a new exemption from registration that is responsive to the unique considerations that arise in virtual space. Like the federal crowdfunding exemption,[60] which seeks to adapt the securities laws to a "relatively new and evolving method of using the Internet to raise capital to support a wide range of ideas and ventures,"[61] this new exemption could seek to further the policy goals of the securities laws while not stifling innovation in virtual space. This proposed solution would depend on Congress's possessing the political will to act. Yet, if courts and regulators consistently apply the securities laws to those virtual transactions that qualify as investment contracts,[62] and if that application unduly inhibits creativity, Congress may be motivated to respond, as it did in the context of crowdfunding.

In conclusion, I applaud Professor Chaffee for his article's unique contributions in an emerging area, and I welcome an ongoing scholarly discussion about the role of the context clause as applied to "investment contracts" and about the application of that clause in innovative spaces, including virtual transactions based on virtual activity.

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60. *See* 17 C.F.R. § 227.100 *et seq.*; Securities and Exchange Commission, Crowdfunding, S.E.C. Release No. 9974, 2015 WL 7273273, at *3 (Oct. 30, 2015)

> Regulation Crowdfunding, among other things, permits individuals to invest in securities-based crowdfunding transactions subject to certain thresholds, limits the amount of money an issuer can raise under the crowdfunding exemption, requires issuers to disclose certain information about their offers, and creates a regulatory framework for the intermediaries that facilitate the crowdfunding transactions.

61. Securities and Exchange Commission, Crowdfunding, S.E.C. Release No. 9974, 2015 WL 7273273, at *4 (Oct. 30, 2015).

62. *See* S.E.C. v. SG Ltd., 265 F.3d 42, 44 & 55 (1st Cir. 2001) (reversing dismissal of the SEC's complaint because, as alleged, the "virtual shares in an enterprise existing only in cyberspace" satisfied the *Howey* test).