

Alternative Fantasy Models Face Legal Scrutiny

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Despite the many legal issues faced by fantasy sports operators, the players' appetites to play fantasy sports games continues to grow. The vast majority of fantasy sports offerings are based on traditional professional sports, including football, baseball and hockey. However, as the industry has continued to evolve, fantasy contests based on other activities and with different business models are being offered. Some of these offerings are creative, but raise additional legal issues. For companies that offer these "creative" models it is critical to obtain a legal analysis prior to launch.



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In a recent enforcement, the U.S. Securities and Exchange Commission shut down a "fantasy" stock picking game for allegedly violating securities laws. Forcerank LLC ran contests where players paid a fee and predicted the order in which 10 securities would perform relative to each other. In each weeklong game, players accumulated points based on the accuracy of their prediction, and players with the most aggregate points received cash prizes at the end of the competition.

According to the SEC, Forcerank's agreements with players were security-based swaps because they provided for a payment that was dependent on the occurrence, or the extent of the occurrence, of an event or contingency that was "associated with" a potential financial, economic, or commercial consequence and because they were "based on" the value of individual securities.

SEC's Legal Analysis

According to the SEC, two provisions added by Dodd-Frank apply to the transactions entered by Forcerank LLC:

Under what is currently Section 5(e) of the Securities Act, it is unlawful for any person to offer to sell, offer to buy, or purchase or sell a security-based swap to any person who is not an eligible contract participant without an effective registration statement.

The Commodity Exchange Act defines the term "swap" to include: "any agreement, contract, or transaction — ... (ii) that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence."

It defines the term “security-based swap” to include: “any agreement, contract or transaction that (i) is a swap as defined in [the Commodity Exchange Act] and (ii) is based on ... (II) a single security or loan, including any interest therein or on the value thereof.”

Based on this, the SEC concluded that the Forcerank entries were security-based swaps as defined in Section 3(a)(68) of the Exchange Act for at least two reasons.

First, each Forcerank entry was a swap because each participant paid to enter into an agreement with Forcerank that provided for the payment of points or cash. Those payments were dependent upon the occurrence, or the extent of the occurrence, of an event or contingency (i.e., the player’s predictions about the price performance of individual securities being compared to actual performance and the player’s aggregate points being compared to other players). Such event or contingency was “associated with a potential financial, economic or commercial consequence” because it was calculated by measuring the change in the market price of an individual security over a period of time and comparing that change to an identical metric based on the market price of other individual securities.

Second, each swap was a security-based swap because it was based on the value of single securities. The term “based on” does not require an exclusive relationship between the payment and the movement of a security. In the Forcerank contests, players received points based on the change in the market price of a single security relative to the change in the market price of other securities. For example, a player would receive 100 points if the player correctly predicted a security to finish first in a contest and it outperformed each of the other securities. In addition, a player could receive cash based on several factors, including (1) that player’s score, which was calculated by aggregating the points derived from the change in the market price of each single security in the contest relative to the change in the market price of other securities; and (2) a comparison of that score to other players’ aggregate points derived from equivalent calculations. For example, a player would receive cash as the first place finisher if the player made predictions precise enough to receive points such that his or her score was higher than the other players’ scores.

Does Locating Outside the U.S. Matter?

In a somewhat analogous matter, albeit not a fantasy-based activity, the Commodity Futures Trading Commission pursued and enforcement action against Intrade.com for operating a prediction market. Some of the prediction markets enabled users to make binary predictions about the price of commodities. Despite Intrade being located in Ireland, the CFTC asserted jurisdiction because a large number of Intrade users were from the United States.

What Other Factors May Cause Concern?

The potential to create variants of classical fantasy sports is limitless, so it is hard to provide a complete list of potential issues. Additionally, any legal analysis is dependent on all of the facts for a given offering. The following are some examples of factors of alternative fantasy offerings that may create an issue: (1) single-player events (e.g., golf, car racing, horse racing, etc.); (2) college and amateur sports; (3) prize pool not pre-determined (e.g., based on number of entries); and (4) winner not determined by accumulated statistical performance of multiple athletes.

Conclusion

The opportunity to offer creative twists on classical fantasy sports exist and can be quite successful.

However, it is critical that these alternative business models be analyzed for potential legal issues to avoid a fate similar to Forcerank. Making matters more complex is the fact that there has been a flurry of legislative activity covering fantasy sports. This can necessitate ongoing review for legality and any states in which the offering should be excluded.

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