January 2012

Paying and Playing

Mark Methenitis

Marco Mereu

Pietro Macchiarella

Steve Nix

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Moderator:

Mark Methenitis

Panelists:

Marco Mereu

Pietro Macchiarella

Steve Nix

Bryan Daley

Moderator: Good afternoon. My name is Mark Methenitis. I am corporate counsel with Metro PCS wireless here in Dallas, Texas. I am also the moderator for today's discussion, formally known as "Paying and Playing." I would like to let the speakers introduce themselves before we begin.

Marco Mereu: My name is Marco Mereu. I am general counsel and vice-president for business development for Regan Mercantile. We are the developers of Evony—a browser-based, massively multiplayer, real-time strategy game—that has been around since 2009.[1] It is well played around the world. In fact, we have had over 24 million accounts established since its introduction, and the game is currently played in 164 countries. We are big proponents of the free-to-play, micro-transactional based business model.

Pietro Macchiarella: My name is Pietro Macchiarella and I am a research analyst with Parks Associates, which is a market research company based here in Dallas. We specialize in video games. Most of our consumer studies focus on the "connected consumer." One of the main things the connected consumer does is play video games. We do many consumer studies, and I will mention some of the consumer data today.

Steve Nix: I am Steve Nix and I am the General Manager of digital distribution at GameStop. I joined GameStop last year in February when they were getting more aggressive with their digital investments. We have purchased a digital distribution company for P.C.—Impulse, Inc.[2] We also purchased Spawn Labs, which is our streaming company, as well as Kongregate, which is one of our largest flash-based gaming websites.[3]

Prior to coming to GameStop, I worked in game development for a decade. I was CEO of Virtual Entertainment, which was one of the earlier development companies involved in P.C. digital distribution. We were an early partner to Valve on the Counterstrike franchise and launched one of the first

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1. *See* Evony, Age II, http://www.evony.com/ (last visited May 21, 2012).

2. GameStop Acquires Spawn Labs, Impulse, Forbes, http://www.forbes.com/2011/04/01/gamestop-acquires-spawn-labs-impulse-marketnewsvideo.html (last visited May 21, 2012).

3. *Id.*; Kongregate Announcement!, http://www.kongregate.com/pages/kongregate-announcement (last visited May 21, 2012).

team games in 2004. I then worked at Id Software for four years where I ran digital platforms for the company and their mobile group.

Bryan Daley: I am Bryan Daley and I am corporate counsel with BOKU.[4] We are a mobile payments company. Our company allows users to use their phone number as an account number for billing purposes. A user can enter her phone number to buy Facebook credits or other virtual goods. She will then receive a text message to confirm the purchase, after which the charge will appear on the cell phone carrier bill.

Moderator: Since this panel will be discussing the new ways that people are playing video games and the new ways they are paying to do so, I would like each speaker to give his prediction of what the coming year will have in terms of the evolution of new payment methods for gaming, whether it is free-to-play or micro transactions, or other payment methods.

Marco Mereu: Regan Mercantile is a big believer in the free-to-play business model. Under this model, there is no cost to play the game. This removes a tremendous number of barriers to users, allowing more people the access and ability to play the game. The game, Evony, for example, is a browser-based game. In order to play, the user only needs access to a web browser.[5] This lack of restriction allows for more potential game-players than if play necessitates an expensive high-end video card or a home console. One of the areas that we watch very closely are emerging markets, especially in India and Africa, where access to computers and web-browsers is increasing exponentially. Those are all potential spending game players.

Pietro Macchiarella: A couple years ago, Parks Associates released a report predicting the trend of the free-to-play space. Some people thought it was too aggressive—we estimated the free-to-play to grow by at least five times in five years in terms of revenue. This forecast has shown itself to be on target, and I think this trend will continue this year.

Another trend we recently noticed was the increasing number of people who are playing games on smartphones and tablets. Any type of frictionless payments that happen on smartphones and tablets are expected to increase. One study showed that as high as 75% of tablet owners play some type of game on their tablet at least once a month. This should ultimately result in an increase in the number of frictionless payments and a growth in payment companies—like BOKU—that facilitate these types of payments. The industry will continue to shift more toward a digital type of experience and there will likely be a rise in the type of problems that are connected to digital distribution.

Steve Nix: There are essentially two types of markets at the highest level of digital payments: the closed system and the open system. Xbox, Apple's iOS, and Facebook with its credits are examples of closed platforms.

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4. *See* BOKU, http://www.boku.com/ (last visited May 21, 2012).

5. Evony, Age II, http://www.evony.com/index.do?PageModule=Static&type= BeginnerTutorial (last visited March 31, 2012).

Here, the companies will get their thirty percent share, and this will continue to be the case. Outside of Facebook, P.C. can be thought of as an open platform. As competition is rising in this space, it is driving down rates and giving payment systems a more commoditized look. Payment systems and open platforms such as these may become more attractive, and there may be a shift toward open platforms, where the tolls extracted by the owners are lower than in closed platforms.

Bryan Daley: I think emerging payment systems will continue to increase the revenue-producing capabilities of video games. For example, BOKU is seeing markets like Indonesia increase in revenue. Even in the United States, we are tapping resources we were not able to in the past because of the rise of frictionless payments. In the past, many people did not have credit cards, or they simply refused to get them. For example Germany is a country that is much more cash-based than the United States. These emerging payment systems, such as BOKU, are creating possibilities of getting new revenue streams from customers.

Moderator: What are your thoughts on the role of the subscription model going forward? It seems as if this model has been dying out for the past year or two. Increasingly more games have either moved away from it or have never adopted the model in the first place, unless for a broader game service.

Marco Mereu: I am not qualified to tell you whether subscription based games are dead. To clarify, the free-to-play model encompasses several different types of games: some are completely free like those on Facebook while some contain micro-transactional models that allow users to make in-game purchases. Within these micro-transactional models, some games require the in-game purchases to excel while others offer the option simply to allow users to personalize characters or add visual effects.

From a business perspective, it does not make sense to limit the amount of money users can spend on your product every month. For example, Evony's payment gateways contain options that allow users to spend up to $3,000 in a single sitting, which people use. This would not be the case under a subscription model. People spend a significant amount of money. We have players who would cancel their cable bill before they would stop playing Evony because that is how they enjoy spending their money and time. I would not understand from a business perspective why a company would want to put a cap on how much players can spend on the game.

Pietro Macchiarella: Parks Associates ran a survey in 2006 asking 2,500 gamers—people who play at least an hour of games per month—how many play MMORPGs (massively multiplayer online role-playing games). At the time, these games were pretty much all subscription-based. In 2006, six percent said they were playing MMORPGs regularly. In 2008, it jumped to fourteen percent. It recently rose to fifteen percent this year. The market for these types of games has essentially been flat for the past three years.

We also asked if people were willing to pay for subscriptions to play more casual games. Only about seven or eight percent responded yes, de-

pending on their age. This study seems to indicate that the subscription-based model is a very limited market. The base of gamers, however, has been growing significantly. From 2008 to 2012, the number of gamers in the United States grew by nearly three times, moving from 56 million to 135 million. While potentially more gamers will begin to use the subscription-based model as a matter of value, when compared to the total number gamers, the number of subscriptions is not growing.

Steve Nix: There is not much developer energy around subscription models these days. Most of the energy is geared toward sticking with the big AAA development, and they have been working on or toward some form of free-to-play.

Moderator: What do you think are the risks versus rewards of either trying to innovate within the free-to-play payment platforms or taking advantage of one of the currently available platforms?

Steve Nix: GameStop has its own payment platforms. One of the challenges with its website was accommodating digital payments. While there was a procedure for credit cards, there was nothing to facilitate digital transactions such as PayPal. We ultimately had to include a separate check-out procedure for digital payments. Fraud was another prominent issue that arose when implementing a digital payment system. When sending someone a physical box, the address and identity can usually be relied upon. Fraudsters generally do not send something to the address of the person from whom they stole their credit card. With digital purchases, however, it is much easier to falsify an I.P. address. The current digital fraudsters are some of the most talented hackers in the world. They constantly examine company defenses in order to find cracks and perpetrate fraud without being detected.

Another issue with digital transactions is the scope of payment methods. While our international websites take into account the appropriate local payment systems, our digital channels must take into account all of the world-wide systems. For example, Germany uses ELV,[6] Poland uses Polish direct debit, and Europe uses mobile payments. Once you go digital, you have to broaden your accepted payment methods.

Moderator: Bryan, I'm sure you have a similar perspective being on the processing end and trying to get developers to sign up with your company.

Bryan Daley: Yes. One of the problems with iOS and similar closed-loop systems on the publisher's side is the fact that they are locked down. This eliminates revenue possibilities for merchants. Specifically, it limits the "stores within stores" model. This model allows you to pay within an application to go from a trial version to the full retail version of the game or to get upgrades within the applications. Many merchants are trying out this model but are unable to do so under Apple's terms of service.

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6.   Netbanx, What is ELV?, http://www1.netbanx.com/resources/glossary/elv-payments/ (last visited April 1, 2012).

In general, these new payment systems are opening new revenue sources. As previously mentioned, with the increase in revenue and virtual currency, there has been an increase in the amount of fraud. In fact, FinCEN—the financial crimes division of the federal government—requires companies to implement certain anti-money laundering programs when certain conditions are met.[7] This is usually the case where a game allows a player to cash out or exchange money between players. There are, however, some areas of uncertainty. World of Warcraft gold-farming with real money transfer is a prime example.[8] Because it is not authorized by World of Warcraft, there is the issue of whether it constitutes cash out. It is uncertain whether this invokes the Financial Crimes Enforcement Network (FinCEN) regulations requiring recordkeeping and the implementation of anti-money laundering programs. This is likely going to be a large issue for future game developers and virtual currency.

Moderator: Like so many other regulatory areas, you then have to make sure you monitor compliance. Once you are out of compliance, the government will request your accounting. With the expansion of FinCEN regulations back in July, it has become a concern, and it encompasses prepaid access, whether it be virtual currency or gift card. It can all be brought under that umbrella, making it potentially problematic.

Marco Mereu: As a developer, you want to provide your gamers with the maximum number of ways to spend money in your game using the most convenient methods possible. At the same time, you have to balance this goal against the risk of fraud against your players and your company. Regan Mercantile has tested offer walls in the past year, which have been relatively popular. Normally, an offer wall transaction is immediate—where the purchased items are transferred instantly into your account. Hackers, however, had discovered a delay in the transaction. They were able to take advantage of this loophole by redeeming the offer wall and obtaining the item, then canceling the purchase before the company noticed the cancellation. Regan Mercantile was thus forced to do away with offer walls.

Companies that do mobile payments, like BOKU, are much more stringent with fraud detection. Ultimately, it is a company's job to ensure that players will not be the victims of fraud. Regan Mercantile's policy is to ban players or delete their account for cheating, botting, or breaching the game's terms of service in some way. This often leads to situations where a former player has spent several thousand dollars doing chargebacks on his credit card, forcing our company to fight with credit card companies or PayPal to recoup some of the money. These are generally long, drawn out fights with

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7.   *See* FinCEN, http://www.fincen.gov/ (last visited May 21, 2012).

8.   Gold-farming is an Internet-age phenomenon in which players in less developed countries collect and sell virtual gold (common to games like World of Warcraft) to wealthier gamers in the developed world. Dave Rosenberg, China bans online 'gold farming', June 29, 2009, http://news.cnet.com/8301-13846_3-10275180-62.html.

very low success rates. This often costs more time and money than it is worth.

Marco Mereu: I just want to touch on Brian's point earlier about Blizzard, gold-farming, and real-money trading. Not just gold-farming, but selling accounts and selling in-game virtual items has been a big, big business, especially overseas. I think the elephant in the room for monetization in 2012 is the fact that Blizzard is taking real-money trading in-house, they are going first party with it. With the new Diablo title releases, Blizzard is going to be running their own real-money auction house for in-game virtual items, which of course Blizzard is going to get a percentage of, and that's monetization. That's a new form of monetization. If Blizzard does that, then it will be looked at as okay to do that, and frankly I think it's better to have some level of control over the process because it's happening anyway. We are seeing virtual items being sold and bought all the time for large amounts of money that you have no control over in a kind of gaming black market. So, if it's going to happen, why not have some sort of control over the process? I think that is what Blizzard is doing right now. They have learned lessons from World of Warcraft over the course of years. We are going to see how that plays out, but really keep an eye on that over the course of the year because that is a big-ticket item.

Moderator: It's interesting that you have mentioned that you do not want to limit someone's ability to give you money from within a game because that's one of the issues with FinCEN. One of the ways to stay within the exemptions is to limit transaction volumes and it's perhaps a lower number than some people would want to allow on a daily basis for certain kinds of players. It's weighing the risk and reward of "well, do we basically throw in the towel and say we are a money services business and comply with all the regulatory elements, or do we try to stay below this threshold, and hopefully nobody gets too mad about it, as a player, that now I cannot buy anymore Farmville dollars."

Marco Mereu: If we put limits on our players, they would be very upset. I get requests to exceed $3,000 in a single purchase, and I have to say, "No, you need to go somewhere else. We are not going to do that." But, we definitely do not want to set limits on how much our players can spend if they want to spend their money.

Pietro Macchiarella: That's one of the benefits of free-to-play. I was talking to somebody today about a European developer who said they were selling items for $50,000, and I think they were selling two a year. It was some Russian oligarch who was buying it. But the point is that there is a market for that, and there is market for people who will spend that much money. I guess you have to meet that demand, but that creates a lot of problems. One of the things we saw in that particular case was that they were treating these customers as V.I.P.s, so it was pretty much like the casino business. They would call the customers and talk to them and send them on free trips and things like that, so they would really pamper the customers.

It's an interesting approach. Maybe getting more personal would solve some of those problems.

One of the reasons why people play free-to-play is actually because, in their perception, they spend less money on gaming. But, what we have seen is that they tend to spend, actually, quite a significant amount of money. Almost nobody says that when they do not spend money, it's because they cannot find a payment method. The good thing is that the variety of payment methods helps customers pay for items when they want to spend, so I think that's a positive thing. Things like the offer wall help them because some demographics do not have access to credit cards or do not have funds at all. That helps them contribute to the game, so I think that's a benefit to the way free-to-play is right now that allows them to participate in the monetization of the game.

Moderator: Marco, your comments a minute ago about credit card charge-backs and all of these issues provides a good segue to the question of virtual goods and ownership. For example, if you are getting these things like charge-backs, or if you have been involved with an illegal transaction, and somehow that gets flagged, then does a party four people downstream who eventually ends up with some of that gold or with that sword or whatever it was, do they end up losing it because they were involved re-motely in that illegal transaction? With so much monetization, how do you see the interplay of real world money and these virtual goods starting to put everybody at odds?

Marco Mereu: I think, as it stands right now, virtual goods do not have real world value. If that changes in the future, and it very well might change, they may have real value. But right now, whenever you play a game where you are buying virtual goods, if you read the terms of service, generally, they have been drafted by very good lawyers. They are going to be very draco-nian, and they are basically going to tell you that you own nothing and that you have no interest in your account and that you are basically using the account and that you have got an end user license agreement. A lot of the terms say, if you are playing a Zynga game or any developer's game in that market, that if you breach the terms of service, then you are giving up your rights or any interest you have in that account, including any virtual items that may be sitting in that account.

This has raised issues, though I have not seen any cases on it recently but it's been talked about, where some states have escheat laws, where if you have abandoned property, that abandoned property has to be turned over to the state. So, there can be a question sometimes when a person's account is banned or suspended, and they have virtual items in that account that have value, whether that property should be turned over. That's to be debated and looked at as it goes forward, but as it stands now, you should be very con-scious of the terms of service that you are agreeing to when you play these games, because for the most part, you do not have any right or interest in the virtual items you have in that account.

Moderator: It seems like Diablo III[9] may be the one to start cracking that door open. I recall a previous title, a Sony MMO, that had similar functionality, but with a Blizzard title, you will have a much larger fan base.

Marco Mereu: You have the Second Life cases and you have cases where people were actually spending real world money for items that they were acquiring in the game. Virtual items, in a lot of the more casual and social games being played, now work a little bit differently. It's definitely something to keep an eye on, and when Blizzard's first party virtual item auction house comes about, you might certainly see some changes.

Bryan Daley: This is definitely an area where terms of service rule the day. There's definitely a lack of law or case law out there. Going off of what Marco was saying, Facebook is a great example in that it's not even considered property. The Facebook terms of service state that you have a license to use your credits. They are revocable at any time by Facebook and they are non-refundable. So, you have essentially, potentially bought nothing. They could just turn around and say, "Okay, we are now discontinuing Facebook credits, what you have paid us is already paid." It's not even really, in their terms, considered property.

The question down the line will be whether this holds up—whether the regulators and courts come back and say "That's not good enough, that's no longer going to apply." It's an open question.

Steve Nix: That's true of basically any digital properties: items, points, games, anything. You always want to stick with selling the user a license and not an actual object. There may be unforeseen situations where, no matter what your intentions are, you may not be able to deliver that item or that game or those points to the user in the future. The only way to protect yourself is with these extremely draconian end user license agreements. They basically say that you can stop delivering that item, service or game to the user at any time that you want at your discretion for any reason whatsoever.

Moderator: With the emergence of things like Bitcoins, is it possible we'll see something like that change where we end up with fully fungible virtual currencies?[10]

Steve Nix: Bitcoin is on its last legs, so it's a good testament for that model, but I'm not seeing anything in that direction.

Bryan Daley: If you go with that model, you have to make sure you have the proper AML (anti-money laundering) and fraud stuff. It's not game related, but I'm reminded of E-Gold, which was a virtual currency with real stuff tied to it, and the directors of that company are now in jail. There are real concerns with real monetary value to virtual currencies.

Pietro Macchiarella: Personally, I do not think we will see anything bigger as a virtual currency than Facebook credits or similar. It will remain in the virtual space, and I do not think we will see something that will be

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9. Diablo III, http://us.battle.net/d3/en/?- (last visited May 21, 2012).

10. Bitcoin, http://bitcoin.org/ (last visited May 21, 2012).

broader. I think the benefit of universal virtual currencies is that it makes the experience of players more frictionless. Especially in the case of less known publishers, the gamer has to trust the publisher and spend money in the specific currency, and sometimes that can cause the players to be more uncomfortable because they have to use their credit card. Having a universal virtual currency helps with that, and that helps justify the high fees that Facebook and others charge because it targets a larger audience. I think that's the extent of the currency we will see.

Marco Mereu: The truth of the matter is that there really have not been a lot of cases that have literally been argued all the way to judgment in the courts over the last couple of years that have a real binding effect on this. The Second Life cases are relatively old at this point. Who knows, at some point in the very near future, somebody may bring a case like this and argue it all the way to the point where we have some type of judgment or new ruling or new standard on what rights somebody should have or would have to virtual currency or virtual items in a game. But, all we can do, from my perspective as a developer, is work with the law as it is right now, try to stay risk averse, and make sure that people understand that if they are not comfortable with the terms of use in the end user license agreement, then to play another game.

Pietro Macchiarella: I think there was a case, and I'm not a lawyer so I'm just talking as a reader of industry publications, but I think there was a case in the U.K. where somebody was actually arrested for stealing Zynga's currency, but I think that the reason behind the arrest was actually that they were disrupting the game and not that they were taking value of the currency.

Moderator: It was an arrest more on a hacking charge.

Pietro Macchiarella: Right.

Moderator: Speaking of unsettled and mildly nightmarish areas of the law, I thought it would be a good time to take a few minutes to discuss the ongoing issues with sales tax and Value Added Taxes ("VAT") that are being imposed on so many of these virtual transactions. And how nebulous and, at times, exceedingly complicated it is to deal with those regulatory agencies and different governing bodies. I know, Steve, I know you have had some interaction with this.

Steve Nix: Yeah, it's interesting. Tax nexus is a huge issue we have to be concerned with. One thing is, as a physical retailer with stores in every state in the United States and stores overseas as well, we face tax nexus basically in every state. There are about twenty-six states that actually tax digital goods, and then there are a number of states that tax physical goods but will not tax digital goods as well. We work with services like Sabrix and others to track, even down to the county level. Obviously, we are not entirely happy that our digital-only competitors only have to pay sales tax in whatever state they might have nexus in. We are definitely supportive of a level playing field there. It has added a massive layer of complexity in our tracking and reporting that we also have to do. Also, we have a strong presence with our physical stores overseas as well. So we have VAT tracking

and management and everything else we have to be aware of and that we cannot just ignore. So, the combination of physical plus digital in our case adds a massive layer of complexity for us.

Moderator: Well, I know one of the things that's been floated out there on a regulatory level is some sort of method of standardization. Because if you have someone making "Tiny Wings" in their garage and then publishing it online in multiple jurisdictions, that sixteen-year-old is not going have a really good barometer for 1) having to deal with multi-jurisdictional tax issues, or 2) if there was a sales tax piece to it too, trying to deal with all of those local level taxing authorities in all the places that it may be sold. Does BOKU deal with any of the tax issues directly, or does it force all the merchants to deal with all their sales tax problems?

Bryan Daley: I honestly cannot speak to much of that. It varies by the country.

Steve Nix: Even on iOS, it's an issue because in the majority of the major countries, Apple collects and remits tax on behalf of the developers, so it's not an issue. But like Tom Mustaine mentioned earlier, there are a lot of countries in which Apple tells you "We do not collect and remit taxes for you." It's basically the Wild West and you are on your own. You may be breaking the law in that country or you may not be. Maybe it's a country you do not care about. It's something like, in Tom's case, and I have lived through this as well, when you are acquired by a larger company that has an international footprint, you suddenly have to be cognizant of these countries where you *may* be breaking the law, but you really do not care about it if you are a much smaller independent developer.

Moderator: Well, and you would hate to land in one of those small countries on the way to your vacation and be arrested at the airport for tax evasion.

Steve Nix: Exactly.

Pietro Macchiarella: I think it's interesting. Again as a non-lawyer, but as a consumer, I have seen that, for instance, in the United States, when you get taxed, you get taxed based on your residency or based on where you purchase the good. But, in Europe, it's actually dependent on where you buy the good. So, it's a taxation of the source. It makes things a little easier because it's essentially a uniform rate no matter where you buy it from. Most companies are based in Luxembourg, for instance, where taxation is the lowest. So I think that's an interesting approach and I wonder if that will be replicated in the United States.

Moderator: Well, on a related regulatory topic—and this is something that Marco and Brian may have thoughts—with the monetization going on, how real is the concern out there that perhaps some game mechanics might implicate the gambling laws? I know, for example, Zynga was investigated based on Zynga poker. With Diablo III introducing this sort of attached-currency trading piece to it, there's a real possibility there that that could be implicated if they have some sort of gambling mechanic in the game as well,

just based on some earlier legal theory on World of Warcraft. How real is that concern and is it anything that you have dealt with directly?

Marco Mereu: We do not have online gambling. I know Zynga is looking into it right now. To me, Zynga has always been at the forefront of really tiptoeing that line, not necessarily with gambling but when you are talking about lottery laws and sweepstakes laws, what you can and what you cannot do. You will see promotions on Facebook where, if you invite your friend, you get a free virtual item. If you are familiar with those types of laws, there are certain requirements that if you meet X, Y and Z, then you are a lottery. If you meet just X and Y, then you are a sweepstakes. Getting a lottery approved is much more difficult, if not impossible, than getting a sweepstakes allowed.

I would be lying if I were to say my company does not bring promotions to me and they say, "We want to do this on Facebook," and I say "Well, no, we cannot do that." Then, my least favorite line ever to hear is, "But, Zynga is doing it!" And then I have to go back and look and see and figure out what exactly they are doing. They have been very good about always removing one of those particular elements that would expose them to those types of issues. In terms of promotions, virtual goods have technically no real world value, so that has an impact on those types of laws. From a gambling perspective, we do not have a gambling element to Evony, but we do promotions and we do have contests where you get chances to win a prize. And you have to be very careful about those because the states and the federal government will enforce those regulations.

Moderator: There was a case a couple of weeks ago that came out that was reinterpreting the Wire Act.[11] That may actually open this up quite a bit more, since the Unlawful Internet Gambling Enforcement Act[12] seems to have kind of stalled, in terms of enforcement from a practical standpoint. All of a sudden, it could be that we see a lot more of that after this case from two weeks ago.

Pietro Macchiarella: Frankly, I think there is room for that and I think some companies will jump into the space. Definitely, Facebook is saying the usual. I think there was IGT, a gambling company out of Las Vegas, that said it was going to invest $500 million in Double Down Interactive.[13] They invested because they see an opportunity there. I was reading in the Economist the other day, if you look at it, for instance, they estimate social gaming's revenues to reach $1 billion between 2010 and 2011. Does anybody know how long it takes the slot machine market just in the United States to reach $1 billion? It just takes one day. The market is huge, so I think any legal hurdles are probably worth fighting for.

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11.   18 U.S.C. § 1084 (2012).

12.   31 U.S.C. §§ 5361–5367 (2012).

13.   IGT Set to Acquire Double Down, Yahoo! Finance, http://finance.yahoo.com/news/igt-set-acquire-double-down-222021139.html (last visited May 21, 2012).

Bryan Daley: In terms of the gambling, I have two points. One is that, in terms of Zynga poker, it depends on the market and the country. Maybe it's another one of the classic "It depends" and "We don't really know," but they are definitely, as you said, toeing the line. Phone Pay Plus[14] is an entity in the United Kingdom that deals with regulating mobile payments and other kind of e-currencies or e-transactions, and they had a judgment recently with Zynga Poker in regards to classifying it as "Adult Themed." Even though it's simulated poker, it's adult themed. Which essentially translated to, on Facebook, they then had to limit which payment options were available for different age groups. So, for example, we can no longer be a payment option for Zynga Poker for customers below either 18 or 19. That's one example where they are toeing the line, as things develop. It still has not been classified as gambling.

Moderator: Well, I imagine you have a concern that, at least potentially, that whoever you are paying out to, if the Unlawful Internet Gambling Enforcement Act[15] were ever enforced, that whoever you are paying out to is potentially a gambling provider that you would have to screen out and how to toe that line.

Bryan Daley: In the last panel, Richard mentioned that social gaming, such as free-to-play is becoming more involved with telecoms. Essentially, this means that game developers are currently looking at game raters like the Entertainment Software Rating Board, and obscenity laws in the United States and various other countries to make sure they are in compliance with those laws.[16] However, what they may not be aware of is that telecoms have their own accepted uses and gambling is an example of a restricted use.[17] One is not allowed to perform gambling and other transactions through telecoms. I cannot necessarily speak about Metro PCS because I have not taken a look at their practices. Nevertheless, there may be other issues, such as payment or distribution in certain areas, that prevent a game from being available on certain avenues. Thus, it is important to verify whether or not you are complying with these terms regarding the content of your games.

Moderator: Moving on to a different topic, over the past three to five years, there have been dramatic shifts in demographics across the playing public. What sort of effects have you seen from those playing shifts in terms of the monetization payment methods? I imagine some of this is fairly obvi-

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14. *See* Phonepay Plus, http://www.phonepayplus.org.uk/ (last visited May 21, 2012).

15. 31 U.S.C. §§ 5361–5367 (2012).

16. *See, e.g.,* Tex. Penal Code Ann. § 43.24 (West); ENTERTAINMENT SOFTWARE RATING BOARD, http://www.esrb.org/index-js.jsp (last visited Mar. 30, 2012).

17. *See* Arthur D. Little, Online Gambling: All In?, TELECOM & MEDIA VIEWPOINT (2009), *available at* http://www.adlittle.com/downloads/tx_adlreports/ADL_OG_01.pdf.

ous, but I would be interested to know if any of you had any particular insight into something that has not been reported?

Pietro Macchiarella: I have already mentioned some of the trends earlier. Overall, we see a larger number of players, which is mostly due to larger demographics. What is interesting is that older demographics are now playing games. The older demographic has access to more payment methods than the younger demographics, and they usually have more disposable income. That is probably a benefit for the industry in general. On the other hand, what we are seeing now is that only the younger players tend to put value on those digital items. That is a little scary because then you have a transition to the digital world. Also, it is possible that the older players do not put the same value on digital items as the younger demographic. I believe that as we see this generation grow, we will see the valuation of digital items become higher in the eyes of the gamers. However, right now we are still in the transitional stage.

Another thing that we have seen is that older people play on different devices as well as multiple devices. It is important to note that people, especially the older demographic which are less tech-savvy, expect to play the same game across all different platforms and expect to use the same payment methods. Currently, this is not always possible.

Marco Mereu: In a free-to-play game the modulation model will have a large amount of players as the base, but only a fraction of those players will be spending players. Nevertheless, developers in the free-to-play genre are paying extra close attention to that small group of the paying players in terms of who they are and when they like to play. Our revenues will fluctuate based on what promotions we are running each day. For example, if we run a particular promotion and we see that promotion is very popular for a particular item, then that is something we will keep in mind. We will be able to run that promotion again knowing that does very well with a particular group and a particular spending component.

How a particular demographic prefers to spend is something we look at on a regional basis. For example, in North America, the majority of payments are performed via credit card or Paypal.[18] Currently, we do not see many mobile payments in the United States. However, I am sure this payment method will start to emerge as younger players continue to play the game. In Europe, mobile payments are quite popular. Thus, if you have a game that is tailored toward that market, then you have to accept mobile payments because that is how the majority of players are spending their money. One must also consider that if you are doing mobile payments or any other alternative to traditional payment sources, then you are now giving up a cut of your revenue. Different countries and different carriers will charge vastly different rates on what cut they want of your revenue. Thus, as a developer, you have to make a judgment call and ask yourself if taking that

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18.   PayPal, https://www.paypal.com/ (last visited Mar. 30, 2012).

payment method in that particular country is going to be worth paying eight, ten, or even twenty percent of what you make.

Bryan Daley: I will counterpoint against the comment regarding the United States payment method. You would actually be very surprised to know there are a lot of people using mobile payments in the United States. We do not release figures, but the United States is actually one of our top five markets. We are a frictionless payment system, which means that a player can only enter their phone number and they do not have to enter their credit card, address, perform a log-in process, or sign up for Paypal.[19] Essentially, a player is already registered, and all their information is provided through their carrier. All that is required is a phone number, and most people have that memorized. Thus, when people see the mobile payment option, they use it. You would be surprised how quickly mobile payments get adopted as a payment option once it is available.

Marco Mereu: BOKU is a great mobile provider, and I am not sure what your carriers in the United States charge for a percentage because I have not looked at the rates lately.[20] Nevertheless, as a developer, you must ask yourself if you want your United States users using a mobile payment. Or you may ask whether you even want those users to have the option to do it because it may cost fifteen to twenty percent off of the top and most people in the United States still use credit or debit cards. Further, you may ask whether you want to pay the premium to a mobile carrier and give everybody a split of the revenues from your game or you want to keep payments based on a credit card. As I mentioned before, in Europe you almost have to offer mobile payments because that is the principle form of payment. Thus, the equivalent in the United States would be not offering credit card payment. But since we are a relatively small company, we must be careful about how much we are going to share. However, as the margins come down in the United States, we will probably begin to look at something similar to mobile payment methods.

Bryan Daley: I would like to further that point. Currently, we are in sixty-six countries, and if you use us, then you would not have to be in every single market because you can turn off certain markets. For example, if you wanted to be heavily present in the United Kingdom but not in the United States, then you would simply "turn off" the United States market, which would enable you to transition into gaining more of an audience elsewhere.

In terms of rates, when I started working with the company in 2009, the rates were quite high. But as volume increases and we gain more publishers on the service, it allows us more leverage in negotiations with the carriers. Currently, the rates are so much lower than they used to be, and they are continuously dropping. As we get more and more use of our service, the rates will drop more because the carriers are seeing this as a revenue stream

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19. *Id.*

20. BOKU, http://www.boku.com/ (last visited Mar. 30, 2012).

for themselves that they did not have before. Carriers view it as a tool for their users.

Moderator: Steve, do you have any thoughts on the demographic shifts? I know that GameStop[21] has been adapting a lot to the changing environment.

Steve Nix: We have pretty wide demographics in our stores. In my experience, when I go to one of my nephew's birthday parties, the GameStop gift card seems to be the most popular gift for teenagers. We see everything from the core player teenager to the eighteen to thirty-four year old male who makes up the majority of the core game buying audience. However, we have parents that come into our stores who may not be buying, may be buying a Wii game for their children, may be picking up casual titles for themselves, or may be picking up a Facebook point of sale activated card for themselves. We see a wide demographic of gamers, yet our online customers tend to be the core eighteen to thirty-four year old demographic. On Kongregate, however, the demographic is all over the place. But we will see more of the older gamers and even more females than we would otherwise see in our stores.

I believe that those gamers are much more active when you look at social mobile games, the online Role-Playing Games ("RPGs")[22] and other games in that genre. It is not just the eighteen to thirty-four year old core male with which you must be concerned, it is really a much broader demographic. Also, there is a large group of gamers who do not even consider themselves gamers. These gamers are the people who will absolutely say that they are not a gamer, but they spent ten hours playing Angry Birds last month.[23] Thus this is a large shift in the demographic.

Bryan Daley: I think Ted hit the nail on the head when he said his mom now uses Angry Birds.[24] We see that there is a huge growth in middle-aged women. It is no longer just the twenty to thirties male that is gaming.

Marco Mereu: For the record, my three-year-old daughter beat my Angry Birds score too. So the demographic can range from mothers to three-year-olds.

Pietro Macchiarella: We did some focus groups last year, and I was shocked by how much those groups knew about Zynga.[25] They knew the brand, the names and they would spend hours chatting amongst themselves about different topics related to Zynga. I would have never thought this

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21. *See* GameStop, http://www.gamestop.com/ (last visited Mar. 30, 2012).

22. An RPG is defined as a game in which players assume the roles of fantasy characters. *See* The Free Dictionary, http://www.thefreedictionary.com/role-playing+game (last visited Mar. 30, 2012).

23. Rovio, http://www.rovio.com/en/our-work/games/view/1/angry-birds (last visited Mar. 30, 2012).

24. *Id.*

25. Zynga, http://company.zynga.com/ (last visited Mar. 30, 2012).

group would actually play these games. It is definitely interesting the way the demographics have evolved.

Moderator: In reference to games my mom plays, Words with Friends actually poses an interesting question.[26] To what extent do you think advertising can supplant direct purchasing revenue? The advertising model proposes that the gamer either deal with the ads or pay to take the ads away.

Pietro Macchiarella: One thing we have seen so far is that advertising is a good component, but it is not really the main source of revenue. Even if you look at Zynga, whose revenue was about twenty million dollars a year, only about three percent of their revenue came from advertising. Such advertising revenue is not a sustainable model for a company like Zynga. On the other hand, we have seen in consumer surveys that younger people tend to be more willing to deal with advertising in their games because they see it as a form of getting free stuff. So, for instance, some demographics are more willing than others to accept advertising.

Another item of interest was discovered in our internal segmentation process. This process is where we segment the gaming population depending on their time spent playing games and the type of games that they play. The most casual segments were very willing to have advertising in the game. However, the core gamers did not prefer advertisements during the games, which is kind of intuitive.

Moreover, some games might be more fit for advertising than others. Demographically, there is an international type of appetite for advertising and some audiences may not prefer any advertising. Also, there are demographic segmentation issues. In general, social gaming is probably the best type of game for advertising because it allows the developer to do branding integration into games. There have been quite a few examples where the physical brand has some kind of advantage for the virtual game. This is an example of a type of potential evolution. But currently, social gaming is definitely one of the best types of games for advertising.

Steve Nix: If you look at GameStop's Kongregate platform, they have over forty thousand games on the site; the majority them being driven by display advertising, which is the type of banner advertisements you see when you play the game. Last time we reported numbers there were over seventy-five games that use the "Kongregate kred system," which is our virtual currency.[27] The revenue from those seventy-five games using "creds" is greater than the other forty-thousand games using advertising. I think most game developers are seeing the same trend and are strongly leaning towards virtual currencies and micro-transactions rather than other forms of advertising.

Bryan Daley: From my experience, I think that the advertising model is kind of a middle ground and a way to get a little bit extra revenue in the

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26. Words With Friends, http://www.wordswithfriends.com/ (last visited May 21, 2012).

27. Kreds, http://www.kongregate.com/kreds (last visited May 21, 2012).

retail model. Rovio is a perfect example with their Angry Birds game because they know a gamer can obtain the shortened version with advertisements in it, which means Rovio is getting some sort of revenue stream for those players that are the casual gamers that do not want to pay for the full version. There is still the retail model that allows gamers to pay to eliminate advertisements. Once the gamer pays, the transactions is finalized, and the gamer receives the full game. In essence, it is a way to off-set a publisher's expenses while using the retail model and continue receiving a little bit of revenue.

Moderator: Hero Academy is another example of one that was in the middle ground. During the initial launch, if a gamer bought the additional "Dark Elves" pack, then no advertisements would be displayed during the game.[28] But there were other things a gamer could buy in terms of micro-transactions that would not necessarily eliminate the advertisements. For example, different avatars and team colors could also be purchased.

Marco Mereu: I think that there is a huge barrier in the mobile market, even if you are a ninety-nine cent application, when you have to get a user to spend money immediately. The gamer has the alternative of downloading the free game instead. So, if you can offer a free version of your application or of your game that has advertising in it, it may be more effective. From a developer's perspective, a lot of people are offering the free game initially in order to get a gamer to play the game and see if they like it. The amount of money that is derived from the small advertisements a gamer sees on a mobile game while playing versus the amount of money that is derived from the Kongregate form is different. But in general, the big benefit of a free-to-play game is that it costs you nothing to create an account, login and play the game immediately.

One of the largest components of our segment of the market is we want to be able to get players playing the game with as little clicks as possible. We want a player to be able to check off a box for "X, Y, or Z," put in an account name and a password, hit play and play the game immediately. I think that is what people really want to do. Developers want to make sure they can at least get a player in the game to see whether you like it or not. If the player likes it, then they have the option to spend a dollar ninety-nine or whatever the charge may be for a mobile game.

Bryan Daley: The other thing to note is that there is potential for more growth in this area. Similar to any advertising scheme, there is always a delay in revenue in the sense that advertisers do not really understand how much value they are going to realize from the advertisement. Returning to an earlier point Ted made, which was that the data provided from games creates a real possibility for extremely targeted advertising if you get the permission to share it. However, when you tie that targeted data in with your sales pitch to get advertising dollars and in your sales in general, there is a potential to

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28. Hero Academy, http://www.robotentertainment.com/games/heroacademy (last visited Mar. 30, 2012).

receive a good amount of revenue from it. The reason is because that targeted data allows you to advertise to the audience that these advertisers want to reach.

Marco Mereu: If you are making a social game, or even if it's a "couch" game on your phone that is supposed to be social or a Massively Multiplayer Online Game ("MMO"), you have to make sure people are playing it. Otherwise, you can have the best MMO in the world, and if nobody's playing it, then it does not matter. It is important to get as many players as possible playing those social games. If that means you must offer a free version that has advertisements in it to get more players in that game world, then a developer must do it. With the monetization strategy that we have and that a lot of free-to-play micro-transaction games have, it is imperative to have a large amount of players in that world even though the vast majority of them are not spending any money. Those players are there to make the game playing experience more enjoyable for the small percentage of players that are spending money.

Pietro Macchiarella: I think, Bryan, you had a very good point about the how advertisers can target specific audiences. I believe it is becoming even more important because some of the traditional audiences no longer watch television or read newspapers. So, in order to reach those audiences in the near future, advertisers will have to shift to another medium. I think gaming will be one of those mediums. We actually have a colleague that covers advanced advertising, and she has been telling me exactly what you said. The traditional agencies do not have the expertise or the knowledge about gaming. That is why many times the budget for advertising is actually included in the traditional budget and not allocated specifically for digital media. In some sense it is more difficult for games to reach these types of spenders.

Moderator: We will cover only a couple more points. We have discussed extensively the desire for players to be able to play cross-platform. That is to say, the ability to play a game on your iPhone and then play it on your iPad, Android, or on your Facebook account. From what you have seen, to what extent does that interconnection of different platforms complicate the payment issue?

Pietro Macchiarella: I believe we have yet to see something that is compelling enough to be deemed a problem. In a free-to-play game, ninety-nine percent of people say that the reason they do not spend money on a free-to-play game is not because of a payment method. So, at least that is not an obstacle for gamers. I think new developments such as cloud gaming are interesting because it allows you to play the same game on multiple platforms with very little difference in the performance of the game. I believe cloud gaming is a good example of something that will make it easier for different platforms to play the same game while simultaneously allowing for the same payment model throughout all these platforms. This will partially eliminate some of the problems that currently exist. For instance, there is a difficulty in being able to play a game they bought on their previous iPhone

and transferring that purchase to their new Droid phone. I think, at the moment it is more of a contents problem rather than a payments problem.

Bryan Daley: Well, I think there actually is a payment blocker. We were discussing the idea that if you originate with a certain market, say Facebook or iOS, some of these areas actually have a condition where you will continue to owe them their cut of the revenue for this customer that originated from them. So there is this idea that they are going to keep trying to get their piece of the pie even if they are being used on a different medium. That is not a legal or regulatory blocker but is more of a negotiation that is going to have to occur between the parties. That is going to have to be worked out, but right now, I think it is potentially a blocker with some of these cross-platform things.

Moderator: I imagine from the developer's perspective that is something that gets to be particularly worrisome. Or, for that matter, that if everybody is trying to take a piece of the pie down the stream, then eventually there is no pie left for whoever made the game.

Marco Mereu: You have to make a judgment call. As a developer, you have to look at what your revenue is, and you have to look at what it is going to cost you. If you are trying to make a social game right now on a platform like Facebook, do you want to pay Facebook thirty percent? You want to pay Google five percent? There are some new platforms that are coming out that you can put your game on. Kongregate[29] is a great platform that many small developers were able to get their games on and do very well with, so I think it is really just a matter of how much can you afford to give and how much do you need to spend to get your game to as many players as possible.

Steve Nix: At GameStop, what we have talked about is to ultimately allow gamers to play their game on any device at any time. One thing we have done with a number of acquisitions is basically—Kongregate has one payment system, Impulse has one payment system, GameStop.com has one payment system—is basically integrating those account authentication systems and payment systems where they all work together so that ultimately a customer does not have a fractured experience. It is something that is extremely important to us. If they go to their PC, and they have purchased a mobile game from us, they should be able to see that in their account. They should be able to buy additional mobile games from their PC. They should be able to buy PC games from their mobile device. So basically, having just that unification of all those payment systems.

And then it also brings in to the international aspect, for a US customer, should we be showing them all these international payment types? Or, if they travel overseas, in their account, are they suddenly going to have some of the more indirect payment methods show up for them? Dynamically, as a

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29. Kongregate, http://www.kongregate.com/ (last visited April 2, 2012).

worldwide distribution company with all these different companies and platforms we are now supporting, it gets hugely complex.

Moderator: Before we open it up for questions, any closing thoughts from anyone? Things that we have touched on that you want to go back to?

Marco Mereu: I would just keep an eye on the first-party virtual item auction house from Blizzard this year with Diablo III.[30] I think it is going to present some really interesting arguments both from a legal standpoint and from a player's standpoint. I am really interested to see how that works also from a business standpoint because monetization is something that is evolving also. Free-to-play and micro-transactions were not really talked about a couple of years ago, and now it is what everybody wants to talk about. That is a new source of revenue that Blizzard is going to have for one of their premier games. And that is a big billion-dollar industry overseas in terms of real money trading. So that is a lot of money that is out there and you are having one of the premier developers in the US basically step up to the plate and say, "We are going to just do this first-party now and bring it in-house, and we are going to make money off it. That is the way we were going to handle it." If Blizzard does it, then maybe it is okay. Maybe other developers will start doing it, and that is another way for companies to monetize their game.

Pietro Macchiarella: We already mentioned free-to-play, and I think that will continue. That's my prediction. Tablets are going to become a primary platform for gaming. They already are. We see retailers like Amazon[31] who are doing really well. One of the reasons is the unified payment method. The fact that they already have millions of customers already on registered payment methods is really going to help them. And they do a really good job at integrating all the different digital items that some customers have into their portal. So I think these are all things that will help in that sense in tablets, and particularly on Amazon.

Steve Nix: Yeah, you are absolutely going to see a further acceleration in free-to-play. There is just so many developers I have talked to that have been developing core games for the last 10-15 years of their lives, and now all of them are trying to arrange venture capital to go out and do free-to-play games. So absolutely an acceleration there. But that is also going to really drive the payments model.

Right now, we have several platforms that are essentially trying to keep these walls up and maintain a fairly high rate, at say thirty percent or so, for essentially just providing payment services. I think you are going to see a lot of companies emerging in that space that really are not worried about running a game publishing portal or anything. They are just worried about pro-

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30. *See* Oli Welsh, Diablo III has real money auction house, Eurogamer.net (Aug. 1, 2011), *available at* http://www.eurogamer.net/articles/2011-08-01-diablo-iii-has-real-money-auction-house.

31. *See* Amazon, http://www.amazon.com (last visited May 21, 2012).

viding plumbing for payment monetization systems analytics. You are going to see competition there. You are going to see that cut really start to decline. Groups like Apple that are trying to maintain these walls are going to start to see a lot of pressure for those to come down as HTML5 gaming emerges. Basically, many developers are realizing they can just provide HTML5 code that runs in a web browser rather than having to deliver a native app to the device. If the device supports web browsing, it's going to support open standards and commodity-like structures for those payment systems.

Bryan Daley: I would just say keep your eyes open in regards to virtual currencies and just be ready to react if something comes down the pipeline in terms of regulation or some big case because as it stands right now, as we said, it is unclear but it is definitely an area that has potential to move drastically. In terms of that, protect yourselves by getting counsel for patents. You definitely want to be consulting counsel in regards to your terms of service and not just copying and pasting some similar kit, game, or something like that. You want to make sure you have got yourself covered.

Moderator: Right, and with something like the FinCEN ruling, you have until March, whatever date of March it is, to get all of that in order. Otherwise, you are outside of the sort of grace period. So, at this point, questions from the audience for any member of the panel or the panel as a whole?

Audience Member: Just a clarification, maybe from Bryan [Daley]. I was curious. I am sure you are familiar with stories where people have had their phone stolen, their credit card stolen, etc. What if somebody actually loses their phone? With a credit card, you are just issued a different card with a different number. But here, it is my phone number, and somebody has it now, and they are just supplying yes to a bunch of these requests. How does that work?

Bryan Daley: There are multiple answers that could go to that question. I think this may answer your question. In that situation, what you would end up doing is you would end up getting a new phone. What would happen is, within your carrier, the phone number would no longer be tied to that old phone. So this is a whole confirmation process that the phone is receiving.

Audience Member: It's not just a phone number then.

Bryan Daley: No, it's not just a phone number. One of the reasons we are secure is because people keep their phones on them. If you lose your phone, you call your carrier and get a new one. What actually ends up happening is, once you put your phone number in, the only other step in the process is you get a text message. And you send another text message back with "Y," which just stands for yes. You are confirming that you want to be charged for this amount. So if the person has your phone, once you have switched it to the other one, they are not going to receive that text message. Carriers have eliminated the whole phone cloning issue and all that.

The phone number is the account number essentially.

Moderator: Other questions?

Audience Member: In advertising, you have the little banner ads and you have the preview ads that go between. We are also seeing that there is advertising you can put in the game. I know Zynga[32] did this model and had a Goodyear blimp. Not only was it sponsored by Goodyear, but they turned it right around and made players pay for that blimp. Essentially, they made money twice. Where do you see that going in the advertising of actually in-game advertising?

Marco Mereu: We have not done too much of that, but I can tell you obviously anybody in the industry monitors what the competitors are doing. I could be wrong. There is no one from Zynga here to correct me, but when Zynga has done a promotion that had Lady Gaga or a big future star,[33] their daily active users jacked up that day, and they had a real strong response to that, so I am assuming that it's worthwhile to do that.

Steve Nix: Yeah, it is going to be very limited though. I mean, that is Zynga, so they are the 800-pound gorilla. It is the same reason that Omega pays James Bond millions of dollars to wear his watch because James Bond is going to be a huge summer blockbuster.[34] But in the majority of films that are made, they are not the summer blockbusters, and no one is going to pay you anything to have someone lift your soft drink or something while they are in a scene. So those particular very custom deals will still happen for the larger properties.

The in-game advertising business model has waned from the way it was talked about back in 2008. There were a few companies that emerged—IGA was one of those companies, and Massive, which was ultimately purchased by Microsoft, was another one.[35] These companies basically allowed for you to be running around a fast-paced action game or a racing game and see dynamically changed billboards and advertisements and stuff in the game. There was a lot of activity around that back then.

I actually worked on a game that was primarily originally supported by in-game advertising. What you found is that it was tough to persuade the advertising agencies and their clients on the in-game advertising. They ultimately were not really interested in the billboard in the game. What they were interested in was the, "Hey, I want you to take one of your characters and turn it into this movie character that is coming out for this new movie we

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32. Zynga, http://company.zynga.com/ (last visited April 2, 2012).

33. *See* Leena Rao, GagaVille: Zynga and Lady Gaga Announce Major Partnership, TechCrunch (May 10, 2011), *available at* http://techcrunch.com/2011/05/10/gagaville-zynga-and-lady-gaga-announce-major-branding-deal/.

34. *See* John Harlow, More than a word from 007's sponsors, The Australian (May 2, 2011), available at http://www.theaustralian.com.au/news/world/more-than-a-word-from-007s-sponsors/story-e6frg6so-1226047962752.

35. Press Release, Microsoft to Acquire In-Game Advertising Pioneer Massive Inc., Microsoft.com (May 4, 2006), *available at* http://www.microsoft.com/presspass/press/2006/may06/05-04MassiveIncPR.mspx.

have next month. Oh, and by the way, I want that character to be able to fly like the character does in the movie and have all these special powers." Then you explain to them, "Well, what you are talking about is six months of game development—completely changing the level design, completely changing the game mechanics." And so, it is just a very difficult conversation. I do not think the in-game advertising model is going to go very far from here.

Moderator: I actually saw a little bit of this before I went in-house. It poses sort of an interesting legal question. That is, when you are doing essentially in-game product placement, you have to make sure you are getting the rights from someone who actually has the rights to give you. There are definitely people out there who are creating 3D assets to tangible goods that have no rights to the brand name associated with that good, or whatever that is, whether that's a coke bottle, or easily recognizable iPod Touch or something like that. There were actually instances where someone said, "Hey you have my product in your game, and you do not have a license from me to do that." Some companies have taken the position that if something exists in the real world, they can put it in the game regardless, and that is sort of a fair use question. Others have taken the position of: if it's not licensed, I cannot put it in there.

Marco Mereu: The recent case that comes to mind dealing with that is Electronic Arts which is engaged with a little bit of back and forth with a military helicopter.[36] The name has escaped me off the top of my head, but I think it's Bell. One of the military helicopter manufacturers and Electronic Arts are kind of in it right now because EA uses their choppers in Battlefield 3. And their company wants to be compensated for the fact that they are using their helicopters in the game. EA argues that it is fair use. That's still going on. I am not sure what the status of it is.

Moderator: EA is actually the one that has taken the hardest line stance in terms of: we can recreate anything digitally that we want to. It really does not matter.

Steve Nix: In that case, it is probably being affected by this theory that once something is used by the military, it is owned by the people and not by companies. You will see a lot of military games that will use the military names of the guns, the tanks, the helicopters, and the planes. If you do a private game, you cannot use G5 for your airplane or something because that is owned privately by a corporation. Anything that is owned by the US military or the government is thought to be basically fair use in games.

Moderator: I have actually seen EA argue that as well on things that are not public items–things that are either covered by patent or trademark that are pretty identifiable as well that are real world items.

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36. Owen Good, EA Invokes First Amendment Protection for Video Games in Trademark Dispute with Helicopter Maker, Kotaku (Jan. 8, 2012), *available at* http://kotaku.com/5874076/ea-invokes-first-amendment-protection-for-video-games-in-trademark-dispute-with-helicopter-maker.

Steve Nix: When Activision[37] did Streets of L.A. and Streets of New York, one of the interesting things they had to deal with is when film companies go out and film in a city. If you use buildings, obviously in your shots or something, you have to pay those buildings a license fee. There are these companies that are entirely set that up and that's all they do. They clear these license fees for use in these films. In that game where you are driving all over L.A. and New York and everything, they had to go through the same process and pay all these license fees to all these buildings that they were using their images of to these companies that work with the license holders.

Pietro Macchiarella: I agree with everybody else on this. I think the in-game advertising, if anything, will be limited to the more casual-social side probably just because the analytics and the fact that they can tweak the game more easily than core gaming and the business dream. If they can make money, they will fit some advertising in there. I think, for the core gaming aside, we will look more on the game advertising. For instance, if you look at the consoles, they are making a decent amount of money on advertising, which is really on the Playstation home, for instance, or on the dashboard on Xbox. I think that is the distinction that we will see.

Steve Nix: You also asked about pre-role and post-role advertising, like WildTangent.[38] I am not sure what their business looks like but I believe they are doing pretty well. If you want to play a game session, they will say, "Hey, do you want to play this?" Then they will show you a video as you are entering the game and a video as you are exiting the game. These are primarily casual games, and I believe that is working pretty well for them.

Moderator: Additional questions?

Audience Member: What have you seen as far as the response of core players to the idea of paying, say, for a premium version of the game where you can access more stuff versus the idea of getting better items or abilities for the character in the same area of the game than people who do not pay?

Steve Nix: I am sorry, are you asking about players basically buying an advantage?

Audience Member: Yeah, what kind of response have you seen, as far as core gamers go who play free-to-play games, the idea of paying for access to nicer areas of the game versus the idea of paying to become more powerful, paying to win, as they call it?

Steve Nix: So basically what you are asking about is premium sections of the game that you have to pay to enter this section, which would be kind of almost similar to buying downloadable content that essentially allows you to unlock a certain area, versus just buying items that you can use anywhere within the game?

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37. *See* Activision, http://www.activision.com/atvihub/search/games.do?keyword=True+crime&submit=SEARCH&site=en_US (last visited May 21, 2012).

38. *See* WildTangent, http://www.wildtangent.com/ (last visited May 21, 2012).

Marco Mereu: The first thing that comes to mind when you ask that is, you really have two kind of free-to-play games out there. There are free-to-play games that were designed with their monetization strategy from the ground up, which is really the best way to do it if you are going to do a free-to-play game. Monetization is a form of game design now. It is simply a fact. If that is how you are going to derive revenue from your game, you need to take that into your game design consideration, and you build it from the ground up. That is how everything was built.

And then you have games out there, like a lot of the newer MMO's, games like Lord of the Rings online,[39] or Age of Conan,[40] you name it, pretty much every MMO, except for a couple of the big ones, have gone from sub-based to free-to-play. It's tough to go back and completely change your game design at that point, but what they do is: well now you can play but you can only play two classes; you can only do two raids; you cannot do all the cool stuff; you cannot wear the cool gear, unless you pay money. I am not a big fan of that personally. I do not think that works really well because I think you segment your users. For me, I like the model where–a lot of people think with Evony you have to spend money to do well in the game. You do not have to. You just get better faster if you do.

There are lots of really good users and big alliances that do not spend money but have just been around for long enough and play the game at a very high-level. They can do that. It is one of those things where I know a lot of hard-core gamers get upset. If I can go into the game and buy the best set of armor in the game that some other guy had to grind for six months to get, that is going to set off a whole section of a user base. So you generally are not going to want to give that ultimate carrot which the hard-core gamer is looking for at the end of the day. Maybe you give a pretty good, medium-tier item that you can buy as a virtual item but you do not give an end-of-the-day item.

For me personally, my favorite free-to-play micro-transaction model out there right now is what Riot does with League of Legends.[41] It is a great product, a great game, and lots of people love it. It is a phenomenally balanced game. Every week they will rotate in different characters that you can use for a week that maybe you get really attached to or you really like or you do really well with. A week later there is a new group that gets rotated in. You will be surprised how fast you pull your wallet out to buy that character, that item, that you really enjoyed. So they have a really great product that is really the fundamental building block for really any kind of game, I would think. You have to have a good game and then give players the feeling that

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39.   The Lord of the Rings Online, http://www.lotro.com/free.php? (last visited on May 21, 2012).

40.   Age of Conan, http://www.ageofconan.com/ (last visited on May 21, 2012).

41.   League of Legends, http://na.leagueoflegends.com/ (last visited May 21, 2012).

they do not have to spend money, but you want to make them enjoy it better if they do.

Audience Member: You mentioned FinCEN[42] a couple of times and the anti-money laundering laws. Can you tell us a little more about those?

Bryan Daley: I do not remember the exact monetary limits, but I think its $2,000 a day or per person. There are exceptions. For example, if you have a closed-loop system, you would not fall under FinCEN. However, when I was talking about the gray areas before, regardless of the exceptions, there are situations where you will be kicked back in under FinCEN. This is whether or not you can transfer between people and cash out. It is a grey area because if you are available to transfer virtual currency between your players and there is also a black market, then you are not going to be providing any cash out and it will still technically be closed loop. However, there is still an avenue for them to get cash from these transactions and the potential for fraud and money laundering. At the present time it is unclear, and we really do not know.

Moderator: International is the one that kicks it out of the exceptions. There are quite a number of resources out there on this topic. A number of places have put together CLEs specific to this. We are essentially looking for a new answer to frequently asked questions that were issued in July that really changed things from what a lot of the legal resources had thought that they were going to be. I do not remember the exact date, but either at the first or the end of March, you either have to be compliant or you are subject to all of these rules. It is sort of the grace period to get people up and going from this announcement in July.

Audience Member: When you have such a giant market in Korea for Blizzard, how does that affect their roll out of that part of the game in dealing with the auction house?

Marco Mereu: From what I understand, I think that they dropped the auction house for the launch in that region. I believe they did not want to wrangle with Korea about it and were just going to release it with the auction house. Korea is not a small market, but it is a different market. If the United States government said to Blizzard, "We are not going to let you release Diablo III in the United States for that auction house," then they would probably have to remove it. However, the United States government is not saying this, so we will have to wait to see what happens.

Bryan Daley: I think that is always the issue. This is especially true when you are international because your markets are going to always have different rules. A perfect example is the App Store and Google Market Place with Taiwan and Taiwan's consumer protection return policies. Taiwan has this seven-day return policy regardless of the reason. A consumer is supposed to be allowed to do this and there is now litigation back and forth between them. I do not know if Google ever turned it back on, but for a

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42. *See* FinCEN, http://www.fincen.gov/ (last visited May 21, 2012).

while they just turned off their market place. Google was basically saying that they were not going to deal with this. It is a similar type of thing because if that comes up, then companies like Google usually have the ability to turn these features off within their markets and they will just handle this market by market.

Audience Member: The majority of games like Call of Duty and World of Warcraft are digitally downloadable.[43] What does this do to the business model? For example, GameStop has a huge profit margin on used games and then all of the sudden that model is more difficult because you cannot resell digital games.

Steve Nix: Although no one knows the exact timing, we do know that, inevitably, the majority of games will be digitally downloaded. There is the technology that is involved, but there is also the chronology that we do not know about right now. In PC games, we know that digital downloads now exceed PC physical game sales. But in the console markets, it is still a great experience to be able to go to a store, buy a disk, pop it into your console, and be playing within minutes and not hours after you download it. I think it will depend on the console manufacturers and where they go. Right now, we still see physical games sales as a very strong business. I think any of us would be guessing trying to run out all of the possibilities on how this is going to play out, but inevitably it will be majority digital, but we just have no idea when.

Moderator: I think that this is the fourth year of Game:Business: Law and that question has been asked every year, so you have at least four years from the proposition.

Steve Nix: And we still have the same answer from four years ago.

Bryan Daley: I think that, at some level, there will always be the brick and mortar. I do not believe it will be near as big, but just in the sense of the same consumer base that we touch a lot with the cash transaction. I know that GameStop, for example sells Facebook credits and Microsoft points in their stores. They are able to do this because there are people who do not want to be paying or putting their credit card on their Xbox or other gaming machine. Instead they want the relationship of the brick and mortar store. Because of this, there is going to be some level of these types of transactions still occurring whether it is because of the payment options or just preference.

Steve Nix: More than half the customers who walk into our stores do not pay with credit cards. Instead, they are using cash, debit cards, or trade credits. There are a huge number of these non-bankable customers who we are able to serve by selling them digital goods in our stores. This is a massively growing business for us. Then, it is a pretty compelling thing to see

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43. *See* Brett Molina, 'Call of Duty' download collection out March 20, USATODAY, http://content.usatoday.com/communities/gamehunters/post/2012/02/call-of-duty-download-collection-out-march-20/1#.T4nzMqvOWDk (last visited on May 21, 2012).

that someone can basically take their whole Playstation 2 into a store right now, trade it in, and walk out with a digital game. We are also taking iOS device trades in a number of our stores. This allows you to take your old iPod into a store, trade it in, and walk out with digital credit. We will continue to adapt and grow with the digital market.

Marco Mereu: Even though most people in this room probably have access to broadband of some sort, not everyone does. I think that until you see everyone across the board having access to high-speed downloads, then it would be hard to imagine only having digital content delivery for all games. You are not going to do that over dial-up.

Pietro Macchiarella: I think this is a problem that all the media in the industry will face, but I think the gaming industry is probably in a better position than others. In music, for example, the digital revolution for music lost them a lot of money. I think one reason is because they did not do it the right way. I think the fact that the gaming industry is taking more time and that all of the download sizes are much bigger than music provides some technical constraints that are actually helping find monetization models that work. I am optimistic about that, but I agree with everybody else that we do not know when it will happen.

Audience Member: In regards to income tax, have there been any entanglements with the IRS or local state taxing authorities in regards to gold-farming where someone is spending real time and getting something that has real tangible market value, then spending that and getting money and having that actually being a taxable event with the IRS? Whereas a developer one would have to worry about that for having issued 1099s for in game asset virtual goods transactions.

Moderator: We were actually talking about a similar idea. The kid in the garage who develops the next iOS game that makes five million dollars and then hits the worldwide button and does not realize that they are subject to income tax in every jurisdiction where they are selling the game. I have not seen any income tax ruling that deals specifically with someone working entirely in gold farming or someone working entirely with legitimate digital distribution or digital behaviors because they are not necessarily aware that they are subject to income tax. From a practical standpoint, if you are doing that and earning revenue, then you are subject to income tax. It is just a question of at what point does the IRS track you down. As dollar volumes go up, it is almost inevitable.

Bryan Daley: It really depends. In terms of individuals, I have not heard of anything. But in terms of companies, IGE[44] was a major company that made the whole gold farming to real money transfer just blow out. They hired people and had this going on within the foundation of a corporation.

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44. IGE is a diversified service provider operating the world's largest secure network of buying and selling sites for massively multiplayer only game virtual currency and assets on the Internet. IGE About Us, http://www.ige.com/about.html (last visited Apr. 2, 2012).

That money would have been taxed, and the question becomes whether or not it is a legal business. However, this is a whole different matter. They were receiving income as a corporation under this business model. In that sense, they would have been getting taxed on this whole idea.

Audience Member: Regarding the whole sweepstakes or lottery issue—what is the best approach to complying with the laws on that? I know that a lot of companies just limit eligibility to the United States, but if you do not want to limit eligibility to just the United States, how far do you have to go in terms of making sure that you are in compliance?

Marco Mereu: You have to go as far as the law says you have to go unless you are going to do some things like some larger developers can do. They are able to mitigate and take risks on and the costs associated with that risk. These litigation costs are essentially part of their development budget where they can see how far they can push the envelope before having to back off. For me, I do not touch the lottery. It is just something that we are not going to do. As far as sweepstakes, Facebook and other promotions are trying to push discovery to get on platforms because you have 750 million sets of eyeballs that can play your game. You are constantly trying to find more ways to get players to look at your game and play it. But you also have to comply with the laws.

From my perspective as a small developer, I do not want any state coming down on me because the states will enforce those laws and pay attention to it. I know that Zynga got attention for that a while back. Many times you see promotions and if you read the fine print you will see that the promotion is only available in X, Y, and Z countries. Sometimes companies will literally do a promotion just for the exposure, but they will limit it to a very remote area. When companies do this, I think they are doing it as more of a marketing technique instead of giving everyone an opportunity to be involved with the contest. If you are like our company based in North America, then you must pay attention to the laws both here and in Canada.

Moderator: If you are trying to manage this as in-house counsel, your best strategy is to look for outside counsel. Having done a little bit of this, if you go international then you can find regionalized counsel almost anywhere. You will probably be able to find counsel in the United Kingdom that knows all the European laws. You will probably be able to find counsel in either Japan or Hong Kong that knows most of the Asian laws. Central and South America are their own issues, but if you can find the right outside partners, especially things like the International Bar Association, this can be the difference between having something going smoothly and ending up having problems in twelve countries.