

Federal Government on the Sidelines

By J. Daniel Walsh

At the end of 2012, an expensive and concerted multi-year effort to persuade Congress to enact Internet gaming licensing legislation ended in disappointment. Supporters were emboldened by an agreement between Senate Majority Leader and gaming industry stalwart, Harry Reid (D-NV), and Internet gaming nemesis, Sen. Jon Kyl (R-AZ). However, legislation on Internet poker could not command sufficient consensus to pass a divided and dysfunctional Congress. So, as the 112th Congress adjourned in December 2012 (and Sen. Kyl retired), stakeholders were left with a daunting, and largely rhetorical question: “If we couldn’t get an Internet gaming bill with Sen. Kyl, how can we possibly get one without him?”

The federal effort had received some momentum from the Department of Justice’s 2011 announcement that it had revised its position on the application of the Federal Wire Act (18 U.S.C. §1084), finding the statute to only apply to sports betting. This revised position, in effect, made clear that states could license the acceptance of any and all non-sports wagering from their citizens. Proponents of federal legislation had hoped that the prospect of states enacting a patchwork of permissive Internet gaming legislation would provide impetus for anti-gaming conservatives to agree to a federal bill that licenses Internet poker on an interstate basis but that would otherwise restrain the states from allowing other types Internet gaming. Sen. Kyl, with his long history of opposing Internet gaming, found the case for such a bargain compelling.

In the end, however, any concern from other anti-gaming conservatives about the possibility of state-licensed Internet gaming was insufficient to drive them to embrace any federal sanctioning of interstate gaming, even if it was restricted to poker. (In fairness, the question was never conclusively tested—Congress was so consumed with larger macro-political issues, that Internet gaming was never elevated to a level where politicians would have had to take a position. However, among Christian conservatives and other anti-gaming conservatives, the proposed bargain never gained much traction.)

So as 2013 began, most stakeholders found themselves substantially reducing their engagement in Washington, and increasing their engagement in certain state capitols. Many believe that sooner or later, Congress will have to enact some sort of overarching standards for player protection, etc., but even these believers feel that several states will have to have acted before Congress gets involved. As of this writing, Senator Reid has made clear that he remains committed to enactment of a federal law, though he has neither introduced any such legislation, nor articulated a strategy for its enactment.

Also, as of this writing, a bill to license Internet gaming, H.R. 2282, has been introduced by Rep. Peter King (R-NY), and a bill to license



Internet poker only, H.R. 2666, has been introduced by Rep. Joe Barton (R-TX). The King bill tracks closely with a bill from Reps. Barney Frank (D-MA) and John Campbell (R-CA), which was considered by the House Committee on Financial Services and reported on a 41-22 bipartisan vote. However, at that time, Rep Frank was Chairman of that committee, and Democrats controlled the House. The current Chairman of the House Financial Services Committee, Rep. Jeb Hensarling (R-TX) voted against the Frank-Campbell bill. H.R. 2282 authorizes interstate licensing of all non-sports Internet gaming, but does not restrict the ability of states to license intrastate gaming or take their lotteries online; such permissiveness seems to be a liability in a House of Representatives controlled by conservative Republicans.

The Barton bill is similar to his bill from the previous Congress (H.R. 2366 of the 112th Congress), and closely parallels the product of the Reid-Kyl discussions. H.R. 2666 would allow only poker but would exempt lotteries, which would be allowed to offer any games legal in their state or by federal law. The bill would also protect existing casinos by limiting online poker licenses to physical casino operations that are licensed to have at least 175 poker tables. However, smaller gaming operators could pool their licenses under the bill in order to satisfy the 175-table requirement. H.R. 2666 would also prohibit the use of credit cards to fund player accounts. In addition, the bill would create the federal "Office of Internet Oversight" and prohibit the issuance of Internet poker licenses to operators convicted of taking bets from Americans over the past 5 years, which would include those convicted from Black Friday arrests. While Reps. King and Barton are strong legislators, given the conservative makeup of the House, few stakeholders view timely enactment of either bill as likely.

As referenced earlier, there remains some belief among Internet gaming proponents that, eventually, there will have to be some federal overlay for multiple state licensing regimes. Consequently, interstate licensing advocates will continue to engage Congress on the issue, but on a much more moderate level. With no clear path to federal enactment in the near term, advocacy efforts will necessarily turn to the states.

As of this writing, only two states have enacted legislation providing for the direct licensing of commercial entities to participate in Internet casino gaming or Internet poker. Nevada's Internet poker regime has launched with limited commercial success, but without regulatory failure to this point. New Jersey has issued proposed regulations with a comment period extending through August 2nd, and hopes to issue licenses in fall of 2013.

This fall, Delaware is expected to go live with a unique hybrid Internet gaming regime. It will be administered by the state lottery, but the state's racinos will serve as marketing portals. The offerings will include house-banked casino games as well as poker.

At least two more states, Georgia and Illinois, have begun selling lottery tickets on the Internet, and additional states are said to be considering it. Conversely, bills have been introduced in several states (Oklahoma, Ohio, and Maryland) expressly prohibiting state lotteries from taking their lottery offerings online. Other states, such as California, Iowa and Illinois, have seen Internet gaming or poker legislation advance to some degree in their legislative process, while states such as Massachusetts, Pennsylvania, New York and (to some extent) Florida, have taken far more preliminary legislative steps.

In sum, we find ourselves in the early stages of what might be described as a post-federal era with respect to U.S. Internet gaming, wherein the U.S. Federal Government neither licenses Internet gaming, nor prohibits it when licensed by various states. As states develop their responses, here are some of the issues they must confront.

- **COMMERCIAL LICENSING VERSUS STATE LOTTERIES.**

The traditional line of demarcation between the operations of licensed commercial gaming establishments and state lotteries has been straightforward. Commercial operators offered casino games, bingo, poker and horse betting at casinos, card rooms, race tracks and through off-track betting, while lotteries offered drawing and scratch-off tickets through convenience stores and other retailers. This line blurs in the realm of the Internet, where the games are not transacted on any particular physical premises, and where distinctions between the types of games are less clear. Many have pointed out that, in terms of player experience, there is little difference between an Internet scratch-off ticket and an Internet slot machine. While few state lottery officials have expressed intent to launch games traditionally associated with casinos, some companies that manage state lotteries have expressed considerable enthusiasm for these games in their statements to investors.

As discussed above, Nevada and New Jersey have chosen to license commercial operators, Delaware has adopted a hybrid model wherein commercial operators work with the state lottery, and Georgia and Illinois have commenced the sale of lottery tickets on the Internet; none of these states, so far, have moved toward allowing the lottery to provide traditional casino games or poker (Nevada's constitution prohibits lotteries), and there is legislation pending in Illinois to license commercial operators for such games.



An obvious driver of state interest in this area is the potential revenue that Internet gaming brings. Both commercial entities and state lotteries will make the case that their offerings will yield more state revenue.

Commercial operators will assert that, in addition to revenue, their entrance into the market will create jobs. The European experience may provide some insight. Ten years ago, most authorized Internet gaming in Europe was conducted by government monopolies. Now, an increasing number of EU countries: the U.K., Belgium, France, Spain, Denmark and Italy, among others, have moved toward licensing commercial operators, and the momentum in Europe is definitely toward commercial operators and away from state monopolies.



• CASINO GAMES VS. POKER.

The first two states to license Internet gaming by commercial operators have taken different approaches on the games to be offered. Nevada currently only licenses Internet poker, whereas New Jersey plans to license casino games, poker, and (if its challenge to PASPA is successful) sports betting. There are strong arguments for both approaches.

Obviously for states seeking revenue, licensing more games yields more revenue, at least from the Internet space. For smaller states, though, it is difficult to generate sufficient player liquidity to sustain a robust Internet poker market; house-banked games are easier to launch, and require less liquidity.

On the other hand, there is some anxiety on the part of brick-and-mortar gaming enterprises (particularly tribal gaming, discussed below) that casino games pose a much greater threat to cannibalize players from casinos that rely on “convenience” players. Poker is a small percentage of revenue for such casinos, and thus they are generally less opposed to it. Many argue that poker can serve as a “pilot program” to better understand the issues involved with licensing other forms of Internet gaming. In addition, poker only holds some political

appeal, in that many opponents of Internet gaming argue that it “brings gambling into people’s living rooms.” With poker, that is where it has been for more than 100 years.

• LIMITATIONS ON LICENSES.

Both Nevada’s and New Jersey’s legislation limits Internet gaming licenses to existing brick-and-mortar casinos within those states, and nearly all other states’ legislation contains some similar form of restriction. In some cases, licensed race tracks or card rooms are also eligible for licenses. Other companies, such as existing European Internet gaming companies, may participate as partners or vendors to those incumbents. While some might advocate a more open licensing system, the reality of licensing is that in regulating in a new medium, regulators are going to be most comfortable with companies and individuals with whom they are already familiar. Furthermore, this model encourages out-of-state interests to provide in-state interests with the software, expertise, and financing necessary to allow them to become successful Internet operators.

• HOW TO TAX IT.

Gaming jurisdictions in the U.S. generally use Gross Gaming Revenue (GGR) taxes as a way to obtain revenue from their operators. In many cases, U.S. GGR rates for brick-and-mortar gaming have been quite high – sometimes in excess of 50%. In the bricks-and-mortar world, such rates are problematic enough, but operators have been able to survive – if not thrive – by supplementing their gaming revenue with revenue from other sources, such as hotel rooms, dining, liquor, shows and retail. However, in the Internet arena, no jurisdiction has produced a thriving Internet gaming sector with an effective GGR tax rate higher than 20%. Poker, with its relatively low margins, struggles even at that rate, and the Nevada tax on Internet poker is wisely set at 6.75%. New Jersey, which seeks to license casino games as well as poker, has set its rate at 20%. Obviously states can only derive significant revenue from an Internet gaming sector that is economically successful; there is a level at which higher rates will yield less state revenue.

• WHAT TO DO ABOUT TRIBAL GAMING.

No state with a significant Indian gaming presence has licensed Internet gaming. Tribal governments view Internet gaming as both an opportunity and a threat, and appropriately so. In states like California, where tribes are quite powerful, it is very unlikely that any legislation can be enacted without broad tribal support, and it is certain that if and when Internet gaming comes to the Golden State, tribes will be major players. However, in other states, the picture is less clear. Most tribal governments are loathe to submit to state regulation, and would probably prefer to use the sort of compacting process found in the Indian Gaming Regulatory Act (IGRA). As sovereign governments, tribes are resistant to the idea of having their gaming enterprises regulated by any non-federal regulator. However, state legislatures have the final say about whom to license to take play from players within their borders. This will obviously yield a tension that different states will have to address in different ways.

- **HOW TO ADDRESS OPERATORS WHO HAVE TAKEN PLAY PRIOR.**

Every state that has considered legislation to license and regulate Internet gaming has required that, in order for an applicant to be approved for a license or certificate of suitability, he or she must be found to be a person of honesty, integrity, good character, good associations, and many other requirements generally included in gaming law. However, in addition, certain bills and laws have issued specific directives to licensing bodies regarding their treatment of companies that have taken play from the U.S. prior to licensing. Some states, such as New Jersey and Delaware, have left it to regulators to determine how to deal with such applicants. Nevada's law prohibits, for five years, the issuance of a license or certificate of suitability to any applicant who was involved in accepting Internet wagers from the U.S. after the enactment of the Unlawful Internet Gambling Enforcement Act (UIGEA) in 2006. Furthermore, in an unprecedented step, the Nevada law renders any acquirer of assets from such a person to be unsuitable. The proposed California legislation has a similar prohibition, but is not time-limited. In addition, the most recent version of Illinois' legislation prohibits the licensing of anyone who has been convicted of accepting Internet wagers from the United States in violation of state or federal law.

Naturally, given the ambiguity in U.S. law, governing Internet gaming -- which, contrary to the assertions of some, UIGEA did nothing to clarify -- one would expect that any applicant who took U.S. play prior to licensing would be subject to a higher level of scrutiny. However, to some extent, such "penalty box" requirements are political creatures driven as much by the competitive needs of certain incumbent gaming interests as concerns about licensing unsuitable applicants. The most obvious evidence of this is the inclusion of assets in both the Nevada law and the California bill. There is no precedent in U.S. gaming law for rendering assets unsuitable; even casinos built by organized crime elements have always been licensable if acquired and managed by suitable licensees.

- **WHAT ABOUT COMPACTING?**

Particularly with respect to poker, liquidity is an essential element. A small state seeking to license Internet poker will find it difficult to create a robust market on a solely intrastate basis. Nevada has recently enacted a law encouraging its state government to seek compacts with other states (and if legal, foreign countries) to pool poker liquidity. As of this writing, no other state bill or law contains such a strong embrace of compacting. Compacting has some limited utility with respect to progressive slots, etc., but is of far less importance for house-banked games.

Intuitively, one can see the efficiency of a system where other states might allow licensees from Nevada to accept play from their citizens in return for substantial taxes from those licensees; it would yield for that state the same revenue without the expense of creating a duplicative regulation regime. However, few with any experience of gaming regulation in the U.S. expect this to happen. State legislators are reluctant to "outsource" protection of players

within their states. Also, states hope to generate jobs as well as revenue from the licensing of Internet gaming, something that this compacting model will not provide. Cynics may also suggest that the states are reluctant to give up the power that comes with their regulatory authority.

A more likely compacting model, at least with regard to poker, would allow a company that is licensed in two different states to pool players from both states on one network or platform. Similarly, if "Company A" is licensed in "State 1" and "Company B" is licensed in "State 2," but both offer poker on the network or platform of a company that is licensed in both states, they could pool liquidity. This would enable players from both states to play together, while ensuring operators interface with players from states only in which they are licensed.

CONCLUSION

With diminished hopes for a near-term federal solution, states are evaluating their options for taking the initiative to license Internet gaming within their borders. While there are many issues that will be addressed by every state that enters the space, each state has a unique political landscape that will necessarily yield differences in the timing and nature of the licensing programs they adopt. Much will hinge on the early success or failure of the programs in Nevada, New Jersey and Delaware -- if those programs yield substantial revenue and happy players, then other states will follow more quickly. If, instead, they provide underperforming revenue, cautionary tales of regulatory failures, or a spike in problem gambling, other states will move more slowly, if at all.



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