SUBMIT, TEST, APPROVE:

Rethinking the Regulation of Gaming Devices

By Mark Lerner

Perhaps no segment of any industry is more extensively regulated than manufacturers of slot machines and other gaming devices and equipment. One way to appreciate the extent to which gaming manufacturers are regulated and to consider the effect this has on gaming technology is to imagine the same regulatory framework being applied to another technology: smart phones. If iPhones and Android phones were regulated in the United States the same way slot machines are:

- Phone manufacturers would have to get the phones approved by one or more government agencies in each state where they want to sell phones. Approvals for new products could take many months and cost thousands of dollars. Approvals for subsequent modifications would take anywhere from a few weeks to a few months and cost anywhere from a few hundred dollars to several thousand dollars. The procedures for getting approval would vary from state to state, and failure to follow the proper procedures could result in delays. Most submissions would eventually be approved, but some products would not be approved for use in all jurisdictions.
- A government agency in each state would establish specifications for the phones. These mandatory technical standards would vary from jurisdiction to jurisdiction. To comply with those standards, manufacturers would have to develop and manufacture dozens or even hundreds of different versions of each phone to satisfy the requirements of all the different jurisdictions. Before manufacturers could implement any technological innovations that contradict or are just not addressed by the standards, the standards would have to be amended, a process that would vary from jurisdiction to jurisdiction, that could take months or even years, and that in some cases would require regulatory and even statutory changes.
- Before shipping a phone from its manufacturing plant to another jurisdiction, the manufacturer would have to notify a government agency in the destination jurisdiction. The notification procedures and requirements would vary from jurisdiction to jurisdiction, resulting in dozens of different regulatory processes to adhere to.

Failure to comply precisely could delay deliveries. Some jurisdictions would prohibit shipping the phones directly to customers but would instead require that they be shipped to the regulatory agency for inspection first; some would require that manufacturers disassemble the phones and ship the phone software to the regulatory agency and the rest of the phone to the customer for reassembly after the agency has authenticated the software. These and other shipping rules would delay delivery to customers and increase shipping costs.

- Before doing any of this, the phone manufacturing companies—Apple, Samsung, LG, etc.—and their officers, directors, major shareholders, and key employees, as well as any distributing companies and their officers, directors, shareholders, and employees, would have to apply for and obtain licenses from government agencies in each of the states where they want to sell phones. The companies and their principals would have to submit detailed information about their personal backgrounds and finances for investigation by the agencies. The investigations and approvals would take anywhere from a month or two to a year or more and cost tens of thousands—in some cases hundreds of thousands—of dollars. In most jurisdictions, this process or a variant would have to be repeated annually.
- Much of the same would apply to apps and peripheral equipment developed for use with the phones, as well as to the networks that enable them to communicate. Different requirements, procedures, and standards would apply in each of the jurisdictions and would have to be complied with before the apps and equipment were shipped and used there.
- For the consumer, a phone purchased for use in one jurisdiction could not be used in other jurisdictions. In fact, it could be a crime even to take a phone from one jurisdiction to another. The consumer would have to get a different phone (and different apps and different peripherals) for each jurisdiction where the consumer wants to use a phone.

What results could we expect if this system were imposed on smart phones and their manufacturers? Few manufacturers would even try to enter the market, and some already in the market might leave, reducing competition and product variety, and increasing prices. Further price hikes would result from the regulatory costs for those manufacturers that did enter and remain. The phones would take much longer to get to market, and innovations and advanced features would take even longer and in some jurisdictions might not be allowed at all. The technology and features in smart phones would always lag behind the technology and features customers see in other consumer products not subject to the same regulatory framework.

This smart phone comparison is reality for gaming equipment manufacturers and their casino customers. Most jurisdictions subject gaming equipment manufacturers to the process described above or a variation of it. First, manufacturers and their principals must be investigated and licensed in some fashion, with most jurisdictions requiring the investigation and licensing to be repeated and renewed at some interval - annually being the most common. In most jurisdictions, this process mirrors the process applied to casinos. But while a casino company is only required to undergo licensing in the jurisdiction where its casino is located, manufacturers must go through this process in every jurisdiction where they market products. For manufacturers operating throughout the U.S. and the world, that is more than 300 jurisdictions.

Second, gaming manufacturers must get their products approved. Manufacturers' products must be developed in accordance with standards developed by government agencies, and the products must be tested by game laboratories operated by the agencies or by private labs approved by the agencies. If the lab finds that a product does not comply with the agency's standards, the manufacturer must modify and resubmit the product until the lab and agency are satisfied that the product does comply. For some products, some jurisdictions require a field trial in which the manufacturer must find a willing casino to operate a few of the machines for a month or two. Finally, the jurisdiction approves the

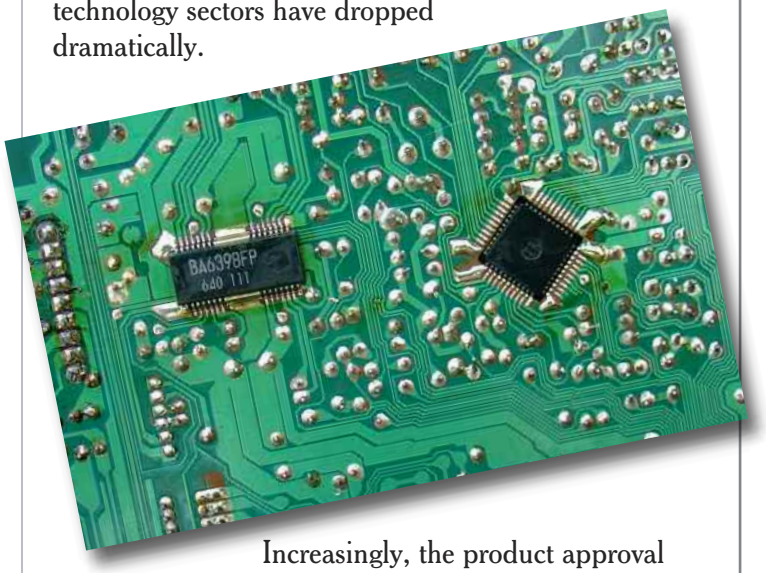
product for use in that jurisdiction. A similar process must be repeated in each jurisdiction where the manufacturer wants to distribute the product.

The product approval model was first developed in Nevada in the 1960s and 1970s when slot machines were operated legally only in Nevada and accounted for a small percentage of overall gaming revenue. There weren't that many slot machines on casino floors, the machines lasted for years, and new models and technologies were not often developed or submitted for approval. Slot machines were mostly coin-operated, mechanical devices with spinning reels that started and stopped by physical means and were vulnerable to manipulation and theft. They were standalone devices, with no network systems monitoring and recording accounting data, player activity, or security information. As other jurisdictions legalized slot machines, first in 1978 in New Jersey and continuing in other jurisdictions beginning in 1989, they tended to reflexively adopt the same prior approval model.

The prior approval model may have made sense when it was first adopted, but time and technological advances have made it increasingly unworkable and costly in terms of money, time, and effects on innovation. Slot machines are now operated in hundreds of casinos in hundreds of states and Native American jurisdictions as well as other countries throughout the world. The number of slot machines on casino floors has multiplied exponentially, and revenue from slot machines and similar gaming devices now accounts for the majority of revenue in most domestic jurisdictions where they are legal. Because of demand by casinos and their customers for greater variety, as well as other competitive pressures, machines and games have shorter average floor lives, and to keep up with demand manufacturers submit thousands of applications for approval of new devices and modifications to previously approved devices each year. This increases the burden on the regulators to keep up with the approvals.

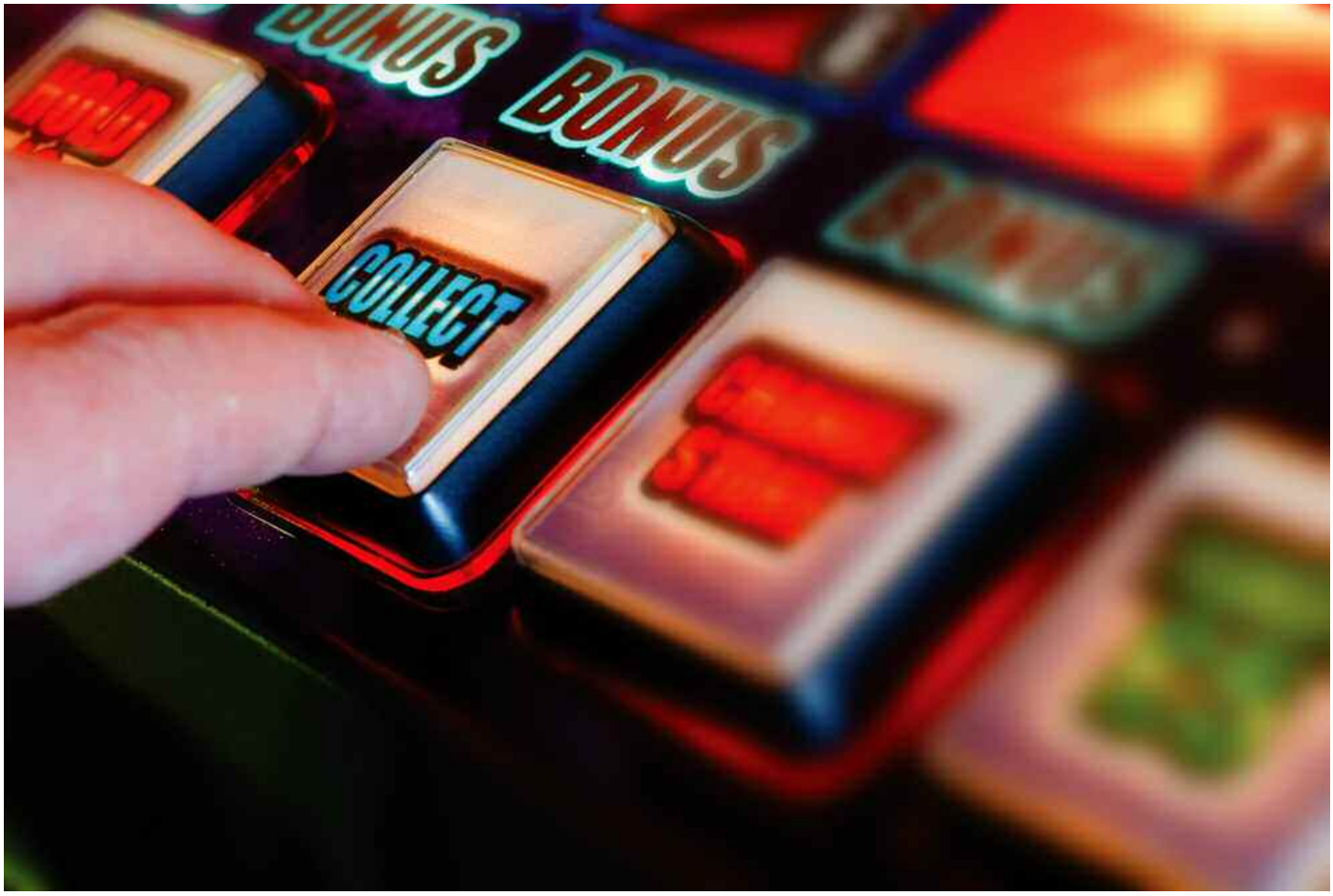
Amending regulations and even statutes to accommodate advances in technology can take months or even years and prevent regulators and manufacturers from responding nimbly to advances in technology.

The inevitable result is a technology lag, where gaming products in casinos are always using technology that is a few years older—some industry executives have publicly said five or even ten years older—than that used in other consumer products. At the same time, the regulatory burden on manufacturers adds to the costs of production, in an era when costs and prices in other technology sectors have dropped dramatically.



Increasingly, the product approval process is unnecessary to achieve the objectives for which it is intended. Today's machines are electronic, computer-based devices that reliably randomize outcomes and ensure honest games. Reels are started and stopped by computer-controlled stepper motors or are virtually created on video display monitors. Coins and coin-handling mechanisms have been replaced by ticket-in-ticket-out technology, bill acceptors, and other ubiquitous, reliable money-handling mechanisms used in ATMs, kiosks, vending machines, and other familiar devices widely used in commerce and finance. Machines are networked to systems that track accounting, player, and security data; that guard against unauthorized access, theft, and cheating; and that let operators and manufacturers know if payouts and holds are not tracking mathematical expectations, in which case manufacturers and regulators can be notified and can respond accordingly. Casino surveillance systems can focus special attention on large-jackpot machines.

Other regulatory processes and economic pressures likewise help achieve regulatory objectives. Licensing manufacturers and their principals and employees serves as a barrier against bad actors. Once licensed, manufacturers' self-interest in maintaining their licenses,



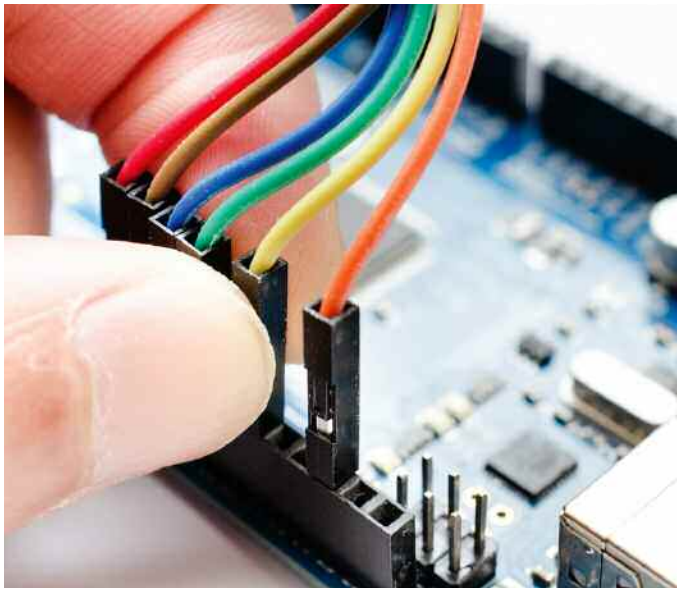
good customer relations, and their places in a profitable, selective market provides further protections, as do encryption and version control software and similar systems used by programmers and other technology manufacturers. Casino operators, too, watch for anomalies in machine operations. If a particular machine or model pays out too much or too often, operators quickly notice and let the manufacturer know about it. Players furnish an additional check. If a machine doesn't pay out, they don't play it as much, and operators notice. If a machine doesn't operate as advertised, players are not shy about telling the casino operators, who in turn notify the manufacturer and regulators. A machine that causes an excessive number of disputes or other problems is quickly recognized and is either corrected or removed.

Thus, economics, technology, and other existing regulatory mechanisms furnish protections that the submit-test-approve model is intended to provide. It is reasonable to surmise that many, perhaps most, of the regulatory objectives of submit-test-approve could be achieved just as well by sample testing after machines are placed in the field, similar to the way casinos are audited. Regulators do not review every casino cage transaction ahead of time. Instead, regulators perform periodic audits, starting with small but statistically significant samples of material transactions. If the samples turn up no anomalies, the audit ends. If anomalies appear, the auditors expand the sample sets. If a wider audit turns up significant problems, they are corrected and the licensee can be disciplined.

A similar model could be applied to gaming equipment manufacturers. Regulators would continue to investigate, license, and re-license manufacturers and their principals. Manufacturers would still be required to build their products in compliance with jurisdictional technical standards, perhaps certifying that they have

done so when notifying regulators of new products deployed in their jurisdictions. Products placed in the field would be subject to inspection and testing on a sample basis, and manufacturers would be subject to discipline for products found to be out of compliance. Newly licensed manufacturers, as well as manufacturers who fail too many inspections, could be required to submit products for prior approval until they establish or re-establish a record of consistent compliance. But otherwise, manufacturers would operate the same as other technology providers, developing products using available technology and distributing them as they become available.

This relatively small modification to the regulation of manufacturers would be expected to yield effects like those seen in other consumer electronics fields, with new technologies and designs being developed and brought to market faster and being tested and refined in real-world crucibles that cannot be duplicated in labs. The casino floor would become more attractive to innovative developers. Manufacturers would be better able to experiment with innovations if the investment of money and time needed for approvals were reduced. At the same time, regulators would maintain control over manufacturers and their products more efficiently through licensing, technical standards, and auditing.



Labs, both government and private, would remain important components of the process, by expanding the use of the labs' brainpower and expertise in what are now frequently secondary functions. Labs would remain instrumental in developing technical standards for gaming equipment, and could expand their important efforts toward standardization across jurisdictions. They would continue to test machines against those standards, although in post-distribution audits rather than pre-distribution testing. Labs would also continue to furnish their expertise to regulators in examining new technologies and assisting regulators, legislatures, and the public in understanding the integrity and trustworthiness of games that implement them. Private labs could also offer testing and certifications to manufacturers who want to outsource compliance functions or add insurance against noncompliance with jurisdictional technical standards.

While in some jurisdictions eliminating prior approvals for gaming products or some subsets of products may require statute changes, Nevada would need at most a regulatory change, since the Nevada Legislature left the decision whether to require prior approval of gaming devices to the discretion of the regulatory agencies.

Changing the timing of product reviews for qualified licensees would hardly diminish regulatory control over the gaming manufacturing sector while bringing the regulation of manufacturers a modest step closer to being in line with the regulation of casinos. Because of the combined requirements for getting products approved and having to get licensed in hundreds of jurisdictions, the costs of regulatory compliance for manufacturers are glaringly disproportionate to those for casinos, especially when one considers that the gross revenue of a major manufacturer may not surpass the revenue of one good-sized casino. Lab and other product approval fees alone for a major manufacturer can easily reach into the tens of millions of dollars annually.

Under these circumstances, the possibility of opening up gaming technology to the rapid innovation witnessed in other technology sectors justifies giving change a try.

Mark Lerner's career as a gaming lawyer includes serving as Deputy Attorney General for the Nevada Gaming Control Board and the Nevada Gaming Commission, private practice at Jones Jones Close & Brown (now Fennemore Craig) representing gaming licensees and applicants, and in-house as general counsel for Becker Gaming Group and Bally Technologies. He also served as Chairman of the State Bar Committee on Ethics and Professional Responsibility and as an officer of the Association of Gaming Equipment Manufacturers (AGEM), and is a frequent speaker at law schools and gaming industry conferences.