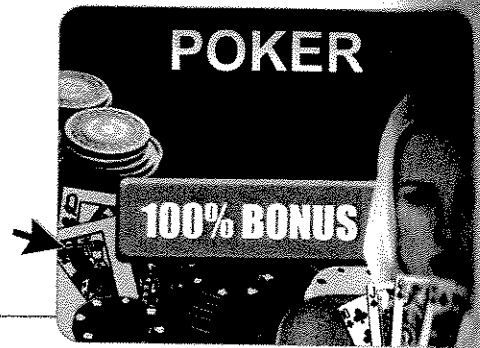


Online

All the Time?

Online Gambling Act Brings New Opportunities, Part I

by David D. Waddell and Robert R. Russell



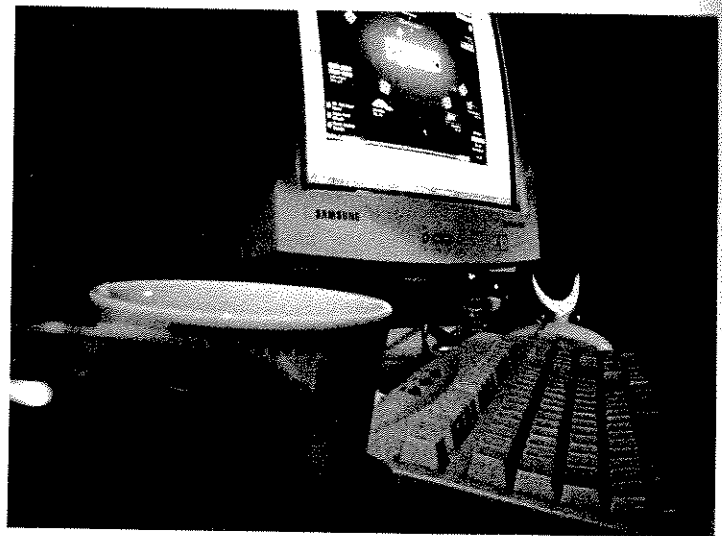
The recent passage of the Unlawful Internet Gambling and Enforcement Act of 2006 has rocked the online gambling industry. On a daily basis, major companies working in the industry have been issuing statements declaring an intention to cease taking, or processing, U.S.-based wagers

From a gaming industry business perspective, much of the immediate focus since the law passed has been on the adverse impact it will have on the existing structure of an industry that has largely operated in defiance of the U.S. Department of Justice's (DOJ) long-held position that such gambling is illegal. Very little focus has been given to the potential opportunities that will arise under the new law for those companies that have approached the internet as a tool to be used for compliant gaming purposes. Although the Act could have, and should have, been given more thought, it contains numerous exemptions that truly outline a roadmap to the long-term future of online gambling. The players in this industry are certain to be those companies that both in the past, and in the future, understand the need for a compliant mindset while laying the foundation for the future of the industry.

Before the 1990s, individuals who wanted to place a casino- or sports-type bet in the U.S. had two choices: they could travel to a legitimate brick-and-mortar gaming establishment or place an illegal wager through a bookmaker. With the emergence of the internet in the mid-1990s, a new form of gambling appeared with online gaming casinos and sports wagering. Today, internet gambling can take place on any electronic device that offers internet access anywhere on the globe. Over 2,500 sites on the internet have provided gambling services that range from casino games to sports and parimutuel betting, to bingo and lottery sales, to the recent poker phenomenon.

Despite the overwhelming popularity of internet gambling in the U.S., the clear negative stance of the DOJ has never really been in any doubt. With very few exceptions, the federal and state governments have been hostile to internet gambling, though large numbers of U.S. residents have routinely gambled online. This clash between policy and reality has discouraged compliant American businesses from investing in internet gambling services. However, several far-sighted companies have invested in the long term future of this business while ensuring that they have been sensitive to, and compliant with, the opinions of the DOJ, state attorneys general and other international governments.

There seems to be no government consensus on how to best deal with the industry. Some governments such as the United Kingdom

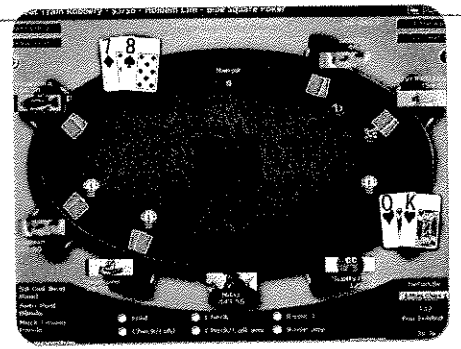
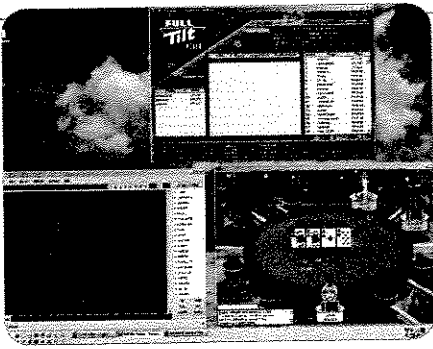


actively endorse, regulate and license. Others vaguely disapprove, but do little. At the extreme end are countries such as the U.S., which has regarded online gambling as a slippery slope.

So let's quell some of the fears and uneasiness caused by uncertainty arising from the clash between policy and reality. We can develop a working framework for investors and operators who wish to take advantage of the future possibilities the internet gambling arena has to offer, without the fear of prosecution for association with an illegal internet gambling operator.

The Legal Framework

There are federal, state, local and tribal laws that apply to internet gambling in the U.S. In general, gambling is a matter of state law, with each state determining whether individuals can gamble, and whether gaming businesses can legally operate within its borders. As a result, laws against gambling run the gamut and are not ideal for tackling the internet gambling problem. Many state courts also face jurisdictional issues in attempting to enforce the laws. Since internet gambling typically occurs through interstate or international means, with a website located in one state or country and the gambler in



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another, federal law is used to protect the states from having their laws circumvented.

To date, much of the legal activity surrounding internet gambling in the U.S. has focused on the federal Wire Act, which was adopted in the early 1960s to address telephone bookmaking. It prohibits gambling businesses from using interstate or international wires to knowingly receive or send certain types of bets or information that could be used to place bets. It has been used successfully to prosecute internet gambling businesses, but contains some ambiguities that many online operators feel limit its applicability, especially concerning the types of gambling it covers. The U.S. DOJ has clearly taken the stance that the Wire Act is not limited to sports-related gambling activities even though case law on this issue is conflicting.

In addition, the Travel Act and the Illegal Gambling Business Act have been used to prosecute gambling entities that take interstate or international bets over the telephone and the DOJ has taken the position that these statutes are applicable to internet gambling activity as well. The Travel Act of 1952 outlaws distribution of proceeds from an unlawful activity across state lines or international borders, while the Illegal Gambling Business Act of 1970 says it's a crime if five people engage in criminal behavior during a 30-day period and generate more than \$2,000 in a single day. Some states have taken specific legislative actions to address internet gambling, in some cases criminalizing it and in others relying on existing gambling laws to bring actions against entities engaging in or facilitating internet gambling. Although the constitutionality of applying these laws to internet gambling has not been tested, it seems likely to fall within the interstate commerce doctrine.

Recent Enforcement Developments

The internet gambling industry was thrown into a state of turmoil in July 2006, when the U.S. DOJ arrested the CEO of a leading offshore internet gambling company, BetOnSports, after his plane touched down on U.S. soil during a trip from Britain en route to his company's offices and his home in Costa Rica. Back in England, BetOnSports shares were suspended from the London Stock Exchange where they were previously publicly traded and the bulk of BetOnSports sites were closed. Federal prosecutors indicted BetOnSports, its CEO, David Carruthers, its founder Gary Kaplan, and other individuals and companies who work with BetOnSports,



and charged them with criminal conspiracy, wire fraud and racketeering for taking sports bets from U.S. residents over the internet and telephone.

For several years leading up to the indictment of BetOnSports, there had been a period of relative inactivity in the U.S. government's crackdown on internet gaming companies. Prior to the July indictments, the most celebrated prosecution of internet gambling under the Wire Act had been the case of *United States v. Jay Cohen*, in which Cohen was convicted for violations of the Wire Act after he established an internet-based sports book, World Sports Exchange, in Antigua that took bets, from the U.S. and elsewhere, on professional and college sporting events. The U.S. government charged Cohen and 20 'co-conspirators' with violating the Wire Act, which makes it a crime to "engage in the business of betting or wagering" using a "wire communication facility" to transmit in interstate or foreign commerce bets or wagers or related information.

In November 2002, The United States Court of Appeals for the Fifth Circuit ruled in the case of *In re: MasterCard International, Inc. Internet Gambling Litigation*, 313 F.3d 257 (5th Cir. 2002) that the Federal Wire Act prohibits electronic transmission of information for sports betting across state lines, but affirmed a lower court ruling that the Wire Act "'in plain language' does not prohibit internet gambling 'on a game of chance.'" Despite this decision, the U.S. DOJ continued to proclaim that federal law prohibits gambling over the internet, including casino-style games as well as sports betting. The DOJ made it clear that the fact that internet gaming operators are not breaking laws in the nations where they run their casinos is of no consequence because, in the view of the DOJ, the wager occurs in the U.S. where it is illegal, as well as in the foreign jurisdiction.

Despite the aspects of the cases that online operators found comfort in, the DOJ made it clear that it was not wavering in its position on these issues. In 2003, the DOJ sent a warning letter to the



Unintended Consequences

The bill targeting financial transaction could threaten integrity of online casinos

Republican lawmakers in the U.S. got their wish in October when legislation targeting transactions between U.S. banks and online gambling sites passed as part of a port security bill signed into law by President George W. Bush. With a stroke of his pen, Bush sent share prices for publicly traded online operators into the tank and online gamblers into an uproar.

Following the news that the measure had been signed into law, reports started pouring in about the negative effects in the United Kingdom, where publicly traded shares plummeted by as much as 80 percent, wiping billions of pounds off the value of many publicly traded companies.

"This has come as a major shock to the industry, where most observers expected the legislation to fail," said Stephen Ford, an analyst for broker firm Collins Stewart. "It also comes as a major shock to the stock market and unsurprisingly stock prices have fallen significantly across all online gaming stocks exposed to the U.S."

PartyGaming, which operates the popular PartyPoker site, lost as much as 62 percent of its value following the passage of the bill in the Senate, and is now down 90 percent after Bush signed the legislation. Sportingbet dropped 73 percent and 888 Holdings slid 50 percent.

PartyGaming, 888 and Sportingbet, which had considerable customer bases in the U.S., announced their intentions to suspend business with U.S. players.

"This development is a significant setback for our company, our shareholders, our players and our industry," PartyGaming chief executive Mitch Garber said in a statement to the London Stock Exchange. "While U.S. horse race betting, state lotteries, fantasy contests and certain other online gaming activities have been exclusively protected under the new law, we are disappointed that the popularity and skill of poker in particular have not also been specifically protected."

888 Holdings said suspension of its U.S. activities would have "a material adverse impact on results for this year and beyond."

Some experts have criticized the online sites for overreacting. They note that the offshore companies are not bound by U.S. law in the first place, and that the legislation doesn't prohibit online gambling, it only changes the way accounts with online casinos are funded. (See Frank Fahrenkopf's American Gaming Association column on page 28 for more details.)

The exit of the larger sites is great news for some smaller casinos to increase their market share. Sites including Bodog, PokerStars, Full Tilt, Absolute and Doyle's Room, announced they will continue to serve U.S. customers, and have seen a dramatic increase in players in recent weeks. The majority of these sites have released statements saying the legislation doesn't specifically target online poker, and doesn't apply to online poker because it is a game of skill. Whether these claims will survive in court remains to be seen, but recent U.S. arrests of online gaming officials have been limited to those who work for sites that accept sports wagers.

The exodus of the publicly traded companies is also opening the market to unscrupulous practices from fly-by-night companies, undercutting the bill's intent, according to the Interactive Gaming Council and eCOGRA.

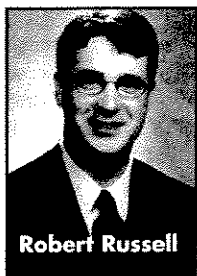
While Majority Leader Bill Frist, who pushed the legislation through the Senate, claimed it would prevent minors from gambling online, protect against problem gambling and reduce the likelihood of online casinos being used to launder money, Keith Furlong, deputy director of the IGC, said the new legislation will drive the industry further underground, noting it actually "increased the possibility of online gambling



National Association of Broadcasters setting forth the Department's view that internet gambling and offshore sportsbooks operations are illegal. Below is a relevant portion of the text of that letter:

"Notwithstanding their frequent claims of legitimacy, internet gambling and offshore sportsbook operations that accept bets from customers in the United States violate Sections 1084, 1952, and 1955 of Title 18 of the United States Code, each of which is a Class E felony. Additionally, pursuant to Title 18, United States Code, Section 2, any person or entity who aids or abets in the commission of any of the above-listed offenses is punishable as a principal violator of those statutes. The Department of Justice is responsible for enforcing these statutes, and we reserve the right to prosecute violators of the law."

Based on all that has been done by the DOJ, it has been clear for a long time that the U.S. government views internet gambling to be illegal. Those who operated in this environment clearly knew they were operating in a very grey area. □



Robert Russell



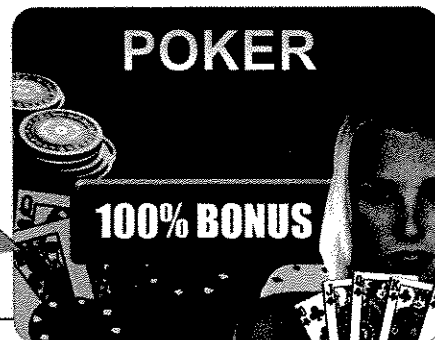
David Waddell

Next month: What is legal and how to set up your company to profit from internet gambling.

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Online Gambling Act Brings New Opportunities, Part II

by David D. Waddell and Robert R. Russell

EDITOR'S NOTE: Last month, authors Waddell and Russell discussed the implications of the approval of the Unlawful Internet Gambling Enforcement Act by the U.S. government. This month, they explain how gaming operators can work within its guidelines.

Although passage of the Unlawful Internet Gambling Enforcement Act was not expected by the industry this year, Senate Majority Leader Bill Frist orchestrated the inclusion of the legislation in the Safe Port Act, a bill dealing with security measures for the nation's ports. Reading through the law, it is interesting to note that in large part, Congress did not intend to prohibit, permit or regulate gambling in the act.

Instead, the purpose of the act is clearly to enhance the enforcement of *existing* state and federal laws by regulating the financial transactions that occur in connection with illegal gambling. In the opening section of the act, titled "Congressional Findings and Purpose," it states, in relevant part, as follows:

"New mechanisms for enforcing gambling laws on the internet are necessary because traditional law enforcement mechanisms are often inadequate for enforcing gambling prohibitions or regulations on the internet, especially where such gambling crosses state or national borders."

Thus, it is clear that in the view of Congress some new enforcement mechanisms were needed to enforce existing prohibitions under state and federal law. In fact, in a provision titled "Rule of Construction," the act clearly emphasizes this point: "No provision of this subchapter shall be construed as altering, limiting, or extending any federal or state law or tribal-state compact prohibiting, permitting, or regulating gambling within the United States."

Money Main Reason

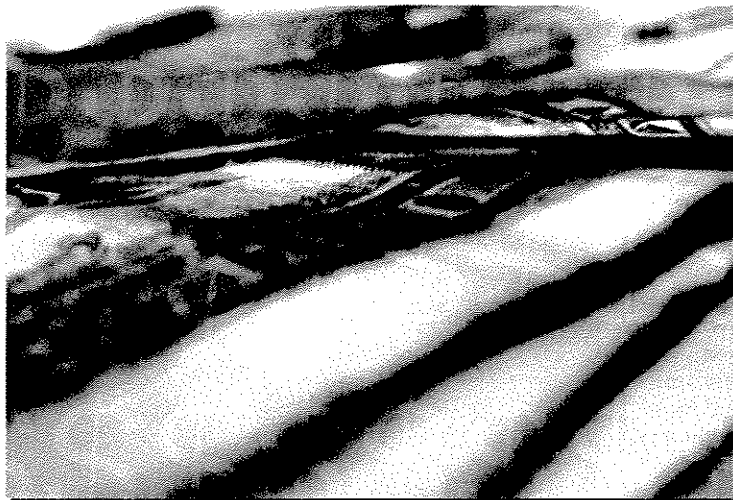
The main thrust of the act is to try to make sure that financial transactions necessary for online gambling to occur are prohibited.

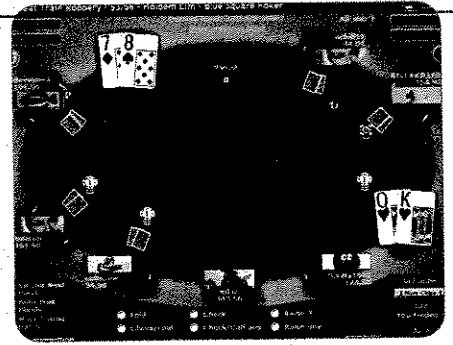
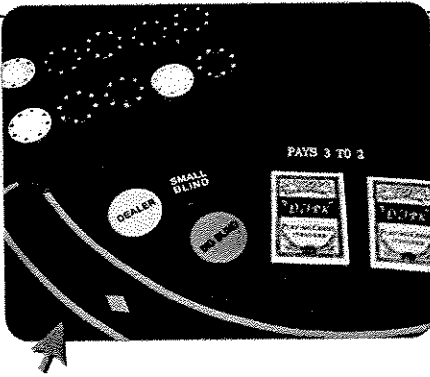
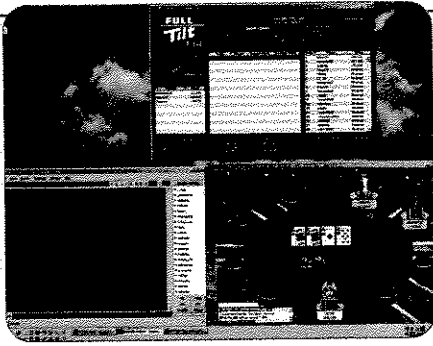
To ensure that this occurs, Congress charged the secretary of the treasury and the Board of Governors of the Federal Reserve System, in consultation with the attorney general, to jointly prescribe regulations to achieve the "establishment of policies and procedures reasonably designed to identify and block or otherwise prevent or prohibit the acceptance of restricted transactions."

As a result of the act, companies that have been deeply involved in what the government construes to be illegal gambling operations have been decimated. Many articles written about the act focus on the perceived unfairness of this development, especially given the exceptions for certain other industry segments such as horse racing and intertribal gaming.

What has in large part been ignored in prior articles discussing the act is the opportunity for the future of internet gambling that seems to have been recognized and acknowledged by Congress in the act. Members of the traditional, compliant gaming industry may have some unique opportunities to lead the next generation of internet gaming sites.

Specifically, the act states that "unlawful internet gambling" does not include wagering where the wager is initiated and received or otherwise made exclusively within a single state, provided that certain criteria are met. These criteria include the passage of state law authorizing such wagering which includes methods for age and location verification, appropriate data security safeguards to prevent unauthorized wagering, and provided that the wager does not violate the provisions of four other federal laws governing horse racing, sports wagering, gambling-device transportation and the Indian Gaming Regulatory Act (IGRA).





'If intrastate wagering was legalized, then companies that participated in illegal activities on the internet would have to disclose these matters, which could adversely impact licensing.'

The intrastate exemption under the new act clarifies existing federal law and provides comfort to those states that have considered the possibility of intrastate internet wagering. Both Nevada and New Jersey have shown some interest in the concept, and with many states struggling to balance their budgets, the passage of the act is likely to lead to more study and consideration of such wagering.

New Jersey Considerations

Several years ago, a proposal was floated to allow intrastate wagering in New Jersey. Internet gambling is illegal in New Jersey because of a prohibition in the state constitution and various criminal statutes in the state. Thomas N. Auriemma, director of the New Jersey Division of Gaming Enforcement, testified before a legislative committee that it would be possible to properly regulate intrastate internet gambling.

In an interview for this article, Auriemma noted that he did not see intrastate internet wagering becoming legalized in New Jersey in the immediate future. He acknowledged, however, that regulation of intrastate internet wagering is possible.

"I was asked by the New Jersey legislature if New Jersey could regulate it," Auriemma said. "I testified yes. Depending on the scope of internet wagering, it is my belief that it would conceptually be easier to regulate than land-based casinos. The various systems for wagering on traditional games or even sports games could be monitored with computer systems.

"During internal agency discussions it was our collective opinion that one approach would be to create 'internet wagering parlors' much like off track betting parlors for horse racing, where people could go to participate in the activity of wagering. These facilities could offer food, etc., to enhance the entertainment experience.

"These facilities could be located in northern New Jersey in areas too far for people to travel to Atlantic City, and elsewhere in the state. Technology exists that would even allow participation in a live game occurring in Atlantic City casinos."

Auriemma added that although some of the regulatory headaches with allowing wagering from home are significant, the possibility of such wagering exists.

"Bets from homes create bigger issues," he said, "but is something that could be looked at. The issues that would need to be



Tom Auriemma, director of New Jersey's Division of Gaming Enforcement, says his agency could regulate online gaming.

verted include age verification, New Jersey resident verification, and other safeguards."

Auriemma noted that the recent passage of the Unlawful Internet Gambling Enforcement Act presents some long-term opportunities for those who have done things right.

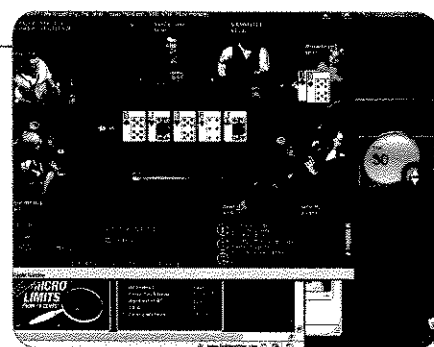
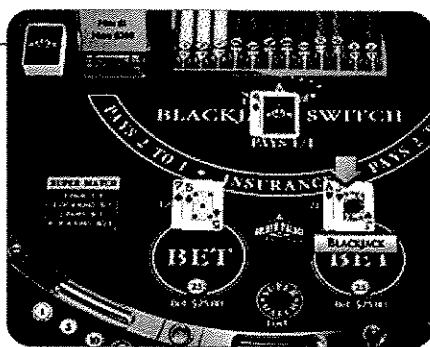
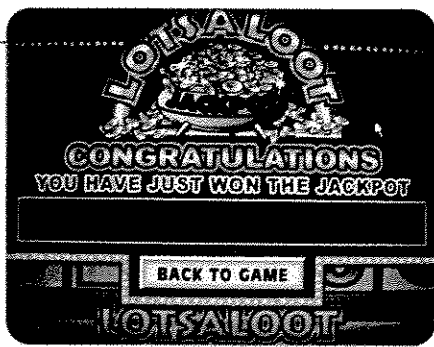
Will companies that engage in internet wagering that is deemed illegal be adversely impacted if New Jersey legalizes intrastate wagering?

"There will be winners and losers," says Auriemma.

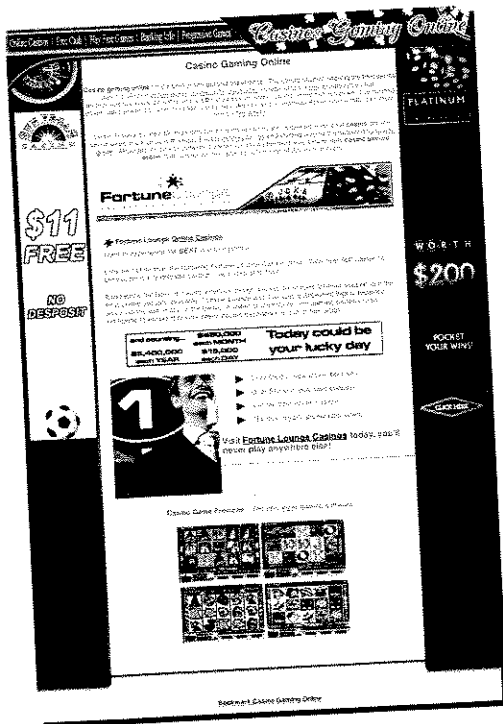
"Companies like Harrah's, MGM and Sun International came to my agency and outlined their plans for internet wagering where legal. We tested these systems and they were robust. However, due to market conditions these sites all closed due to competition from illegal sites. Therefore, if intrastate wagering was legalized, then companies that participated in illegal activities on the internet would have to disclose these matters, and these matters could adversely impact licensing."

The Next Generation

There are numerous opportunities that will arise for members of the traditional gaming industry as a result of the act. States looking to develop online wagering will need the technological assistance and gaming management expertise that is found in this industry.



'Companies that have taken a very cautious and legally respectful approach to the use of the internet for gaming are well positioned to reap the benefits and rewards that compliance can bring.'



Winners from the passage of the new law will be companies and individuals who have developed technologies to ensure age and location verification of bettors. In the short run, these technologies are likely to become more important in the international marketplace, as online gaming regulators in other countries look to develop systems to ensure

wagers are not made.

Notably, the act calls upon the U.S. government to negotiate with foreign nations to encourage cooperation. In the long run, these same technologies will be important for the successful launch of intrastate wagering in the U.S.

There are several keys to participating in the next generation of online gambling. One is to know your business partner. As this industry evolves, it will be critical for companies to conduct very thorough due diligence on any parties they get involved with.

Given the long history, outlined above, of a very clear stance that was articulated by the DOJ with regard to the illegality of internet gambling, it is doubtful that any gaming regulator working within the U.S. would look favorably on the involvement of someone who worked in this shadow industry in the past. If technologies are to be acquired from such companies as their values plummet, great care and caution needs to be exercised to ensure that transactions are strictly arm's-length contracts, rather than a relationship that might be viewed as a joint venture or partnership.

Another key to success in the new online industry is compliance. It is important for a company to have a keen sense of the laws in any jurisdiction in which it operates or accepts wagers. The inadvertent mistake of accepting a wager from a party in a location

that prohibits such wagers could result in long-term licensing problems as intrastate wagering operations, or international online wagering operations in licensed jurisdictions, develop.

The new online industry is likely to develop in a manner that is very similar to the way the bricks-and-mortar industry developed when organized crime was removed. Compliance will be key, and companies that truly commit to compliance will win in the long run.

Similarly, to avoid dramatic downturns in value, investors should be cautious before putting their money into internet gambling company stock. Investing in companies that continue to accept U.S.-based wagers puts investors' money at great risk. Thus, the key to long-term success for gambling websites will be an ability to demonstrate compliance and strict adherence to licensing standards.

Clearly, there will be many companies hurt by the passage of the new law. However, there will also be many winners. There are numerous companies that have taken a very cautious and legally respectful approach to the use of the internet for gaming. These wise companies correctly guessed that the day would come when

Congress would take action to clarify U.S. internet gambling laws.

Now, they are well positioned to reap the benefits and rewards that compliance can bring. They will be the leaders of the new frontiers of intrastate regulated wagering as this sector of the market emerges. ■



Robert Russell



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