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December 9, 1997

BY HAND

Thomas C. Rubin, Esq.
Daniel C. Becker, Esq.
Assistant United States Attorneys
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Southern District of New York
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Internet Sports Gambling

Dear Tom and Dan:

As promised, enclosed is a memorandum summarizing events at the Internet gambling "symposium" recently held in Washington, D.C.

Please feel free to call with any questions.

Sincerely yours,



Lorin L. Reisner

Enclosures

December 9, 1997

To: Bruce P. Keller
Lorin L. Reisner

From: R. Townsend Davis, Jr
Heidi M.V. Sullivan

Internet Gambling Conference--Enforcement Issues

Below is a brief summary of remarks and materials presented at the First International Symposium on Internet Gambling Law & Management on November 11-13, 1997 in Washington, D.C.¹ This memo focuses on enforcement issues, rather than developments in technology, marketing, and issues facing special operators (i.e., Indian tribes and state-sponsored lotteries).²

The majority view at the conference was distinctly pro-Internet gaming, fueled by a Gold Rush mentality about future profit opportunities. The Wire Wager Act, the Kyl bill, and state law, to the extent they were discussed at all, were not viewed as insurmountable obstacles. The majority of speakers stated that because the gaming industry would inevitably grow, self-regulation or a regulatory model of the sort now governing land-based casinos was appropriate.

The sessions were well attended by entrepreneurs, gambling regulators, prosecutors, the FBI, lawyers and academics. Approximately 240 people appeared to attend the conference. Notably absent were any participants from land-based casinos.³

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1. A list of topics and conference speakers is annexed hereto as Exhibit A.
 2. A separate memo dated November 21, 1997 highlighted the sports gambling aspects of the conference.
 3. We have audiotapes of all conference presentations, as well as all the written handouts distributed to participants. A list of conference participants is not available (the organizers kept this information confidential at the express wish of attendees), and the press was excluded from the conference. Another conference on Internet gambling is scheduled for June 1998.

BK 00016

I. WELCOMING REMARKS, INTRODUCTION AND OVERVIEW

Participants: Dawn LaRochelle, Milbank, Tweed, Hadley & McCloy, Editor-in-Chief of *Gaming Law Review*; Joseph Kelly, J.D., Ph.D., Gaming Consultant CCT USA, Inc., Chair of International Bar Association Section on Sports and Gaming, Associate Professor of Business Law at the State University College at Buffalo; Anthony Cabot, Lionel, Sawyer & Collins.

LaRochelle described two ends of a spectrum: those who want to ban Internet gambling entirely and those who foresee a \$10 billion industry within the next three years. She urged participants to help create effective regulation to ensure the proper development of on-line gambling.

Kelly pointed out that no U.S. politician has come out in favor of regulation, which differs from the views expressed in many other countries. According to Kelly, Internet gambling may currently be legal in New York and California, while Wisconsin is the state most aggressively prosecuting it. He cited three legal defenses to enforcement action: (i) lack of minimum contacts under the due process clause, (ii) the First Amendment, and (iii) the commerce clause of the U.S. Constitution.

Cabot outlined two possible strategies for the U.S. government: (i) international enforcement of its criminal statutes, or (ii) international treaties aligning U.S. criminal statutes with those of other countries. He described treaties as unlikely given the great divergence of international attitudes towards gambling. Cabot predicted that U.S. enforcers will target the "weak link" in Internet gambling--Internet service providers--rather than operators or bettors. Cabot also predicted that prosecutors will next go after financial providers (VISA, e-cash, etc.), advertisers, and index providers (search engines that provide links to cybercasinos).

According to Cabot's hand-out, anti-gambling laws will dissuade legitimate businesses (e.g., cable operators) from entering the field, but such laws will not result in a gambling-free environment. In fact, sports bettors will be willing to make illegal sports wagers over the Internet as long as it is no riskier than placing bets with illegal bookies. Sports International, an off-shore sportsbook operating at www.gamblenet.com, is cited in Cabot's hand-out as having netted \$6 million in 1995 (up from \$2.4 million in 1994).

II. FEDERAL OUTLOOK FROM THE UNITED STATES

Participants: **Albert Angel**, Interactive Communications Network; **Cory Aronovitz**, Cooper Perskie Law Office; **Kevin Mercuri**, Interactive Services Association; **David Safavian**, principal, Merritt Group; **Sue Schneider**, RGT Online, Inc.; **Mark Tratos**, Quirk & Tratos.

Schneider is chair of the Interactive Gaming Council (IGC), the leading organization endorsing self-regulation of Internet-based gambling operators. She said true interactive, Internet-based wagering has increased from 15-17 sites in January 1997 to approximately 75-80 sites worldwide today. Although land-based casinos have steered clear, she says they are probably developing test models not just for the Internet, but also for in-room, in-flight and satellite-based interactive gaming. She said there are approximately 15 companies offering interactive gaming software and support.

The IGC was founded a year ago to formulate a Code of Conduct for interactive gaming operators and to address the issues of compulsive and underage gambling.⁴ It currently has 45 members.

Tratos is an intellectual property lawyer who said he has handled electronic gaming patents. He said that due to the uncertain scope of the Wire Wager Act, many Internet gaming site operators are reluctant to release hard numbers on customers or dollars handled. However, he said disclosure of ownership and staff by such operators and disclosure of odds is essential to gaining the trust of customers and regulators. He encouraged operators to share information with the IGC or each other. He noted that at least one company has set up a satellite-based link to avoid the Wire Wager Act, although it is too expensive (\$7,000-\$8,000 per customer) for mass marketing.

Safavian gave an update on the Kyl bill, which he said was likely to move forward during the new Congressional session in January. He said the bill has formidable election-year momentum with about 11 Senate co-sponsors and 43 House co-sponsors. Both political parties have reasons to back the bill: Republicans aligned with the Christian lobbies are against gambling generally and are wary of the Internet, while Democrats may be eager to appear tough on crime and protective of children. New language may be added to protect Indian tribes, state lotteries and pari-mutuel racing.

4. A copy of the IGC Code of Conduct is annexed hereto as Exhibit B. Schneider submitted written testimony, which included the IGC Code of Conduct, to the Senate subcommittee hearings on the Kyl bill in July.

Mercuri said the first on-line casino appeared on August 18, 1995. It was much less expensive than opening a "real" casino, requiring only \$1.5 million and 17 employees. Mercuri warned that the Kyl bill was a "hostile regulatory beachhead to the Internet," and noted that Senator Kyl opposes all gambling in his home state. The IGC, in an effort to affect the shape of the bill, has given technical briefings to Congressional staff and argued that the Kyl bill presents free speech threats similar to those posed by the Communications Decency Act recently struck down by the U.S. Supreme Court.

Mercuri noted that the IGC Code of Conduct was designed to operate like a Good Housekeeping seal of approval. It seeks pledges from sites to adhere to the Code and to provide a link on their sites to the IGC to file complaints. He said the IGC had already conducted mediation for six to nine months "on an unofficial basis" and that Sue Schneider was the chief mediator.

Aronovitz, a former gaming regulator from Illinois, emphasized the importance of a disclosure level of 5% ownership interest or more in any Internet-based gaming operation. He applauded the efforts of some operators to procure insurance to assure winnings are paid out. One regulatory proposal is the creation of an organization funded by offshore host countries (e.g., the Caribbean nations) to create a uniform system of license fees, regulation (including background and spot checks), and penalties.

III. ENFORCEMENT AND COMPLIANCE FOR INTERNET GAMING

Participants: David Stewart, Ropes & Gray; Peter Djinis, U.S. Dept. of Treasury; Steven Davis/Cheryl Campbell, Quixotic Solutions, Inc.

Stewart, a lawyer, stated that the Internet gaming industry should build a culture of compliance (currently lacking) but vigorously defend its free speech rights in advertising.

Campbell said that enforcement has focused on disclosure of ownership interests, background checks, and financial accounting. Her company, Quixotic Solutions, purportedly designs software to insure fair play through a multiple key system built into the game architecture. Players and regulators can check for fairness at the end of each transaction by choosing a "Verify" icon.⁵

5. She said the potential for low-cost monitoring is great because, as illustrated by card games, the regulator can participate in the shuffling of each electronic deck before each hand is dealt.

Djinis, who said he has monitored bank and casino money laundering operations, said cybercasinos have a potential for illicit use, particularly given the potential for high volume trades and the ease of masking identities and erasing evidence. A regulatory system must allow meaningful access to gaming records, and operators should be required, as casinos are, to report suspicious activity to the authorities. He emphasized the importance of uniform and inexpensive cheating detection technologies.

IV. CRIMINAL LAW AND THE FUTURE OF INTERNET GAMBLING

Participant: Paul Hugel, Clayman & Rosenberg.

Hugel, a criminal defense lawyer who said he has represented people in the gaming industry, expressed surprise at the lack of discussion of criminal law at the conference. He outlined the well-known federal acts (Wire Wager Act, Travel Act, RICO) and added that the money laundering statute (18 U.S.C. § 1956) was broad enough to cover Internet casinos and exposes operators to heavy penalties, including a minimum of 46 months in jail and fines of up to twice the amount of money handled. Turning to the Wire Wager Act, he stated that current law makes clear that operating offshore is no defense, citing the McDonough and Blair cases. He said the 1995 sentencing of Ron "The Cigar" Sacco, who pled guilty to Wire Wager violations committed while in the Dominican Republic, confirms this view.⁶ Hugel expressed skepticism about current efforts to take advantage of the Wire Wager Act exception for transmissions between two gambling-legal jurisdictions. His view was the exception covers only information assisting in betting, not betting itself.

Hugel noted that, in addition to federal law, two thirds of states criminalize gambling generally. Several have a state counterpart to the Wire Wager Act, and in some instances states punish the bettor in addition to the gambling operator. Some courts have endorsed the theory that if web advertising is accessible in a state, the advertiser is subject to that state's general jurisdiction. Although he said this theory was questionable under due process, states such as Minnesota and Missouri can assert jurisdiction by seeking an injunction, followed by a contempt order if the injunction is ignored.⁷

6. According to press reports, Sacco, who ran what some consider to have been the largest illegal sports betting ring in U.S. history, was sentenced by a U.S. district court judge in San Francisco to 68 months in prison and fined \$75,000.

7. Hugel noted that a Pennsylvania court recently honored a Missouri court's contempt finding against a Grenada-based Internet gaming company (Interactive Gaming and Communications Corp.) indicted for promoting gambling in

Hugel recommended the following to minimize one's risk of prosecution:

- (i) make sure your operation is truly a foreign entity (with no assets, no officers, and no employees in the U.S.);
- (ii) operate under a license of the jurisdiction in which you are located;
- (iii) make reasonable efforts to take bets only from states in which it is not illegal to place bets; disclaimers alone (i.e., "If you are logging on from Minnesota, you can't bet") may not be enough -- one must attempt to screen out certain users;
- (iv) comply with injunctions to avoid contempt orders.

V. SPORTS AND HORSE RACING ON THE INTERNET

Participants: Jay Cohen, World Sports Exchange (WSE); Michael Shagan, consultant, former official of New York Off-Track Betting; Linda Goldstein, Hall, Dickler, Kent, Friedman & Wood.

According to Cohen, WSE is the only on-line sportsbook offering "true interactive wagering" and wagering after every play of a game. He said WSE is regulated by the government of Antigua, which conducts thorough "FBI" checks on "everyone" associated with the company. Cohen claimed operators are kept honest by word-of-mouth condemnation on web sites such as www.odds wiz.com and rgtonline.com. He claimed Antigua is selective in whom it licenses and lists true licensees on its own web site, www.atgftpzone.com.

Cohen endorsed the "virtual visit" theory of gaming, claiming bets placed through WSE take place in Antigua. He said players must wire money to Antigua before they can play (he said no credit is offered), and Cohen said he viewed this as "no different than moving money from one off-shore bank account to another." According to Cohen, WSE is "a totally foreign company" with no agents in the U.S. and no operations taking place in the U.S. Cohen characterized efforts to regulate Internet servers outside a jurisdiction's boundaries as "unrealistic," citing a recent column that identified more than 30,000 U.S. state and local jurisdictions. He said WSE had taken care of concerns about underage gambling by registering with various "watch" services (e.g., SurfWatch, Net Nanny, Cybersitter) and had posted Gamblers Anonymous links on each WSE page to address compulsive gambling. He claimed sites such as WSE would not exacerbate

Missouri. According to press accounts the lower court has been overruled by a Pennsylvania Superior Court. Pending further appeal the company's principal, Michael Simone, is prohibited from leaving Pennsylvania.

potential fixing of games and that the main problem was the integrity of the players. When asked if he had ever encountered any difficulties with enforcement authorities, Cohen said that he hadn't "heard from anyone in particular" and asserted: "We run a clean operation." He added: "We don't hide from what we do, we get a lot of good press." Cohen, the only Internet gaming operator to present at the conference, was well received by the crowd.

Shagan bluntly stated that Internet operators cannot ask U.S. policymakers to ignore current law: no sports betting, except that on pari-mutuel racing, is allowed in the U.S. He said regulation of the racing industry was a good model for Internet gaming operators because it maintained the primary enforcement power of the states and already functions to some degree in 30 states. He traced recent historical developments in the racing industry: betting on races in other states via simulcasting, telephone account wagering (legal in eight states), and pooled payouts between states. He said a pilot cable system (1,000 homes) currently operating in Louisville, KY allowed real-time odds and betting through the cable box on six to ten racetracks at a time. He said the Kyl bill might follow the same progression as pari-mutuel legislation at the federal level: defeats of bills that sought broad bans on interstate pari-mutuel racing followed by approval of a more moderate bill passed with the support of the pari-mutuel industry. He suggested the following reasons why the pari-mutuel industry might be looked upon more favorably than other types of gaming:

- (i) the house has no stake in wins or losses;
- (ii) the outcome is determined by a tangible event (a horse race), not just a computer-generated algorithm;
- (iii) there is an element of skill in selecting winners;
- (iv) wagering on horse racing is legal in most states;
- (v) the horse breeding industry provides jobs and benefits the state;
- (vi) credit is not accepted;
- (vii) interstate wagering by phone is already accepted in eight states;
- (viii) wagering data is public and thoroughly audited; and
- (ix) penalties for violations in one jurisdiction are honored in other jurisdictions.

He said that if the Kyl bill did not pass, New York State Senator William J. Larkin, Jr., chair of the New York State Senate Committee on Racing, Gaming and Wagering, might require every Internet gaming operator who has New York customers to register with the Secretary of State and to post a bond to insure winners are paid.

Goldstein, a lawyer, said that states varied widely in their treatment of fantasy sports leagues, which are distinguished by having a prize, consideration (i.e., an entrance

fee), and elements of skill. Some states simply forbid betting on contests of skill. Others use the dominant factor test: if skill, not chance, controls the final result, the game is legal. New Jersey law takes the minority view that if chance plays any role, the game is not legal. Montana is the only state that specifically allows fantasy leagues by way of statute. Attorney General opinions disapproving of fantasy leagues have been issued in Florida, Louisiana, Ohio, and a 1972 court decision in Washington state struck down a nine-week football forecasting contest based on the presence of chance elements.

She said that ultimately, the legality of the game depends on how complex the game is and how much control the player has: full-blown rotisserie leagues are likely to be legal in many states. However, this is an untested legal area, and disclaimers (i.e., ESPN's web site says "this is a game of skill") might not immunize a fantasy league from legal risk. According to Goldstein, the Kyl bill would rule out fantasy games, even small-scale promotions, because of the presence of entrance fees.

VI. THE VIEW FROM THE STATES

Participants: Alan Kesner, Wisconsin Department of Justice, Chair of Internet Gambling Subcommittee of National Association of Attorneys General (NAAG), Fredric Gushin, Esq., Managing Director of Spectrum Gaming Group, Albert Angel, Interactive Gaming Council.

Kesner said NAAG had been out front on enforcing laws against Internet gaming since June 1995. According to Kesner, prosecutors are not attacking Internet gambling as a vice so much as they are asserting states' rights to enforce their own consumer protection policies. Because of fragmented state law, NAAG has concluded that federal legislation is necessary; thus, NAAG supports the Kyl bill. He rejected the notion that Internet betting is commercial speech entitled to First Amendment protection. He also rejected the theory, endorsed by some in the pari-mutuel racing industry, that the Wire Wager Act currently permits many forms of interstate phone or Internet betting. In response to questions, Kesner stated that if four criteria for Internet gaming could be demonstrated, some concerns would be alleviated (though no operator had met his standard to date):

- (i) location-based protocols (one must be able to verify the location of users and operators to know what laws they might be subject to);
- (ii) integrity of the games;
- (iii) integrity of the payment systems; and
- (iv) satisfactory background inspections and credible licensing.