

LOS ANGELES

Daily Journal

THURSDAY,
OCTOBER 12, 2006

— SINCE 1888 —

OFFICIAL NEWSPAPER OF THE LOS ANGELES SUPERIOR COURT AND UNITED STATES SOUTHERN DISTRICT COURT

Forum

Government Shows Its Hand in Legislation to Curb Internet Gambling

By Tony Young

The virtual landscape of the \$12 billion online gaming industry may have changed during the early morning hours of Sept. 30, when the House and Senate passed the Unlawful Internet Gambling Enforcement Act of 2006. The president is expected to sign the bill into law within weeks.

The measure, which was passed as part of the unrelated Port Security Act, prohibits banks and other businesses that transmit or process money from making payments to online gaming sites on behalf of those placing or receiving bets within the United States. While passage of the legislation caused Internet gaming stocks to plummet as much as 60 percent, it does little to clarify what constitutes unlawful Internet gambling. Rather, the focus has shifted to the banking sector and the federal regulators, who now must draft enforcement measures to prevent restricted transactions without overwhelming U.S. financial institutions.

The Act provides that “[n]o person engaged in the business of betting or wagering may knowingly accept” credit, electronic fund transfers, checks or other proceeds of financial transactions “in connection with the participation of another person in unlawful Internet gambling.” While the Act does not expand existing definitions of unlawful Internet gambling, the new legislation, instead, targets the lifeblood of the Internet gaming industry — payment processors (such as NETeller) and the offshore casinos’ access to U.S. banks.

Because the legislation doesn’t criminalize online gambling, prosecutors will need to establish illegality through other state or federal laws for the Act to be used to block funds to online gambling organizations, most

of which are located overseas.

Although the Department of Justice has relied on several existing statutes in prosecuting Internet gambling, the most common tool is the 1961 Wire Act, which prohibits one engaged in the business of betting or wagering from using a “wire communication facility” to transmit bets (or information assisting in the placing of bets) in interstate or foreign commerce. 18 U.S.C. Section 1084. For years, the Justice

The practical and legal hurdles that remain may lead prosecutors to find that the 2006 act lacks the teeth necessary to curb the online gaming industry’s sustained penetration into the U.S. market.

Department has maintained that the Wire Act prohibits all Internet gambling, including sports betting and casino games such as poker, blackjack and slots. However, several federal courts, including the 5th U.S. Circuit Court of Appeals, concluded that the Wire Act applies only to sports-related Internet gambling. See *In re MasterCard Int’l Inc.*, 313 F.3d 257 (5th Cir. 2002). As a result, online casino gaming (apart from sports-betting) has existed in a state of uncertainty and questionable legality. The recent boom in online poker has amplified the call for clarity in this area of the law.

Although the 2006 Act does not extend the scope of the Wire Act, it does arguably broaden the government’s ability to curtail Internet gambling as it prohibits access to U.S. financial institutions for purposes of making a bet or wager “upon the outcome of a contest of others, a sporting event, or a game subject to chance.” The inclusion of the language “or a game subject to chance” (which is absent from the Wire Act) fills a hole left by the Wire Act to capture online

casino games. This provision appears to be drafted broadly enough to apply to poker, although some state courts, including several in California, have found that poker “predominantly implicates a player’s skill.” *Bell Gardens Bicycle Club v. Dept. of Justice*, 36 Cal. App. 4th 717, 744 (1995).

No doubt aware of this distinction in a number of jurisdictions, federal legislators removed the term “predominantly” from earlier versions of the bill, thus arguably

avoiding the debate over whether the outcome of a game is predominantly subject to skill or chance.

Prosecutors may be able to attack Internet casinos and their payment processors through the 2006 Act if the illegality of such games can be established through other state or federal statutes. State attorneys general are given express authority to enforce the Act to prevent an actual or threatened violation. In addition to various state statutes that purport to prohibit Internet gambling, several federal statutes have been used in Internet gambling prosecutions in recent years, including: (i) the Racketeer Influenced and Corrupt Organizations Act; (ii) the Travel Act (18 U.S.C. Section 1952); (iii) the Illegal Gambling Business Act of 1970 (18 U.S.C. Section 1955); and (iv) the Professional and Amateur Sports Protection Act (28 U.S.C. Section 3701 et seq.)

While the 2006 legislation breaks new ground by potentially forcing Internet gaming companies to find non-U.S.-based revenue sources, the practical and legal hurdles that

remain may lead prosecutors to find that the 2006 Act lacks the teeth necessary to curb the online gaming industry's sustained penetration into the U.S. market.

Effect of Act

Publicly traded online casino companies took a hit to their share values as a result of Congress' anti-gambling measure, yet because of jurisdictional and practical limitations on the ability to regulate foreign-based Internet casinos, sportsbooks and the payment processors that service them, the 2006 Act appears on its face to put the burden on U.S. financial institutions to identify and block the acceptance of prohibited transactions. However, the banking sector obtained some important concessions that may mitigate this.

The 2006 Act will be enforced through regulations drafted by the Federal Reserve and the Federal Trade Commission—both of which presumably appreciate the challenges faced by banks. Federal regulators will not only have discretion regarding the scope of the regulations, but also they will be required to exclude certain transactions that pose unreasonable burdens associated with identifying and blocking prohibited transactions.

The Act excludes the activities of a financial transaction provider from its definition of those engaged in the business of betting or wagering, and provides specific exemptions from liability for financial institutions that refuse to honor restricted transactions. Financial transaction providers are also granted limited relief from injunctions.

Ultimately, banks, and the rest of the

gaming industry, will have to wait until the federal regulations are written to assess the full effect of the Act on financial institutions in the U.S. - a process that may take up to 270 days after the Act becomes law.

The legislation also takes aim at those who provide payment processing services to bettors and online casinos. Under the Act, prohibited betting or wagering broadly includes instructions or other information "pertaining to the establishment or movement of funds by the bettor." In other words, the Act will likely be construed broadly to include facilitators such as NETeller and Click2Pay as being engaged in the business of betting or wagering if they are involved with the movement of a bettor's money.

"Financial transaction providers," all of which will be subject to the regulatory enforcement schemes implemented by the Federal Reserve or the FTC, are also defined broadly to include money transmitting businesses such as payment processors. Most of the payment processing providers that service the online gaming industry are located overseas, however, so the practical and jurisdictional limitations faced by prosecutors may ultimately undercut the effectiveness of these enforcement provisions.

Fantasy Sports

In addition to exemptions for horse racing and state lotteries, federal legislators have exempted several other actions from being defined as betting or wagering activities under the Act, including participation in fantasy sports leagues (subject to certain limitations). By deeming fantasy sports

operations to be legal, Congress chose an interesting place in the sand to draw a line, thus providing critics of the legislation a platform from which to question the distinction that has been drawn between fantasy sports games and casino games such as poker.

Although the drafters of the Act based the legality of fantasy sports on outcomes that "reflect the relative knowledge and skill of the participants," proponents of online poker sites argue that poker requires at least an equal amount of knowledge and skill to be successful, and that the outcome of a poker game is no chancier than a fantasy sports contest. However, given the express carve-out provision for fantasy sports, the practical effect of the Act will be that unlawful Internet sports betting and casino games will be governed by the Act, while fantasy sports leagues will not.

Though public gaming companies lost billions of dollars in value almost immediately after passage of the bill was announced, only in time will we be able to measure the lasting impact of the new anti-gambling act. Much will depend on how strictly federal regulators draft enforcement procedures, and how broadly courts are willing to construe the scope of the Act's prohibitions. In the meantime, the prudent gambler will stick to weekend trips to Las Vegas or the horse track, and when wagering over the Internet, choose fantasy leagues over the major leagues.

Tony Young is an attorney in the entertainment, media & communications group of Sheppard, Mullin, Richter & Hampton, and co-chair of the firm's sports industry team. He practices out of in the firm's Century City office.