

PENNSYLVANIA VICE

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GAMING LAW

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Online Gambling Rising as Industry of Interest

Pennsylvania Gov. Tom Corbett's administration has clearly indicated that it sees opportunities in the Marcellus Shale industry. By creating an attractive and stable regulatory environment and low tax rates, the Corbett administration hopes to create an economic center for the shale industry in Pennsylvania, much like Houston is the center of the domestic oil industry.

The Corbett administration may soon have another new industry to chase — online gambling. The industry is driven by the popularity of online poker, which took a bad beating itself after reports surfaced alleging three of the industry's biggest websites — Poker Stars, Full Tilt Poker and Absolute Poker/Ultimate Bet — were running a Ponzi scheme and swindling users out of their money.

U.S. Senate Majority Leader Harry Reid, not coincidentally from Nevada,

is leading an effort to legalize online poker. Legalization would allow his state's large players to take advantage of April's U.S. Department of Justice crackdown, which has created a massive disruption in an industry that had been thriving overseas.

A HUGE POT

According to a Goldman Sachs report, gamblers wagered over \$30 billion in online poker rooms in 2008. Despite being illegal in the U.S., Americans were responsible for more than a quarter of the total. The profits, approximately \$4.8 billion worldwide and \$1.4 billion from American players, were huge, and were probably larger in 2009.

Goldman Sachs has predicted that the online gambling market in the U.S. might total \$12 billion if legalized. Before the crackdown, 70 percent of the online market was dominated by Poker Stars and Full Tilt. The remaining 30 percent is spread over several significantly smaller sites.

KNOW WHEN TO RUN

However, Poker Stars, Full Tilt and Absolute Poker/Ultimate Bet, were indicted in April for violations of the Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA), operation of illegal gambling, wire fraud, money laundering and conspiracy charges. The sites also face civil litigation. The Department of Justice issued a second round of indictments in May, effectively shutting down

10 more websites.

While these gambling charges alone are significant, Full Tilt may have even more serious problems. Last month, the U.S. Attorney for the Southern District of New York amended its civil complaint, alleging that Full Tilt was using its cash on deposit in furtherance of an alleged Ponzi scheme.

In addition to the relevant corporations, the Justice Department also indicted several of the key individuals. As a result, almost all online poker companies have taken action to prevent U.S.-based people from gambling online. These actions, however, have not eliminated the demand for online gaming and the gamblers are seeking alternatives.

The brick-and-mortar casinos, most of which are part of a small handful of strong brands, have moved to fill the void by increasing their poker advertising. In addition to redirecting some online players to brick and mortar casinos, the increased advertising has helped the national casino brands supplant, at least in part, the brand identity and player affiliations that used to belong to the online ventures.

CONGRESSIONAL POKER

After working for many years against online gambling, a few years ago traditional gaming lobbyists in Washington switched their tune and started advocating for legalization — and strong regu-

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lation — of online gaming. These leaders, in conjunction with much of the Nevada and New Jersey Congressional delegations, have moved from questioning whether the anti-fraud technology was sufficient to insisting that a strong consumer-protection regulatory scheme be introduced at the state level within an overarching federal framework.

These efforts came closest to legislative success last December when Reid attempted to attach a rider legalizing online poker onto the bill extending the Bush tax cuts. Although the effort failed, it is widely expected that Reid will try again.

What is also uncertain are the details of any federal online gaming legislation. In June, Rep. Joe Barton, R-Texas, introduced in the House a variation on the bill Reid proposed last year. It, like several other related bills, are all sitting in the Subcommittee on Crime, Terrorism, and Homeland Security, and it is widely expected that Reid will attempt to attach some version of one of these bills to ready-to-move legislation. All of the bills getting serious consideration at this time permit only online poker, and either explicitly or implicitly leave UIGEA in place with respect to other online gambling.

While Reid's 2010 bill allocated tax revenues by formula between the player's state, the host casino's state and the federal government, that is not a common element of the bills under review by the Republican House leadership. It is unclear if the House will go along with this allocation formula or if it will leave these issues to the respective states. It also importantly limited online poker to casinos that were already otherwise licensed by state regulators.

Reid's next vehicle may be coming soon. Late last month, he tweeted that "online poker would create jobs: and lots of jobs" in his Twitter "town hall." The focus of the jobs language, combined with Reid's and President Obama's insistence that the "Super Congress" ad-

dress job creation, suggests that Reid could ask the Senators he appointed to the Super Congress to try to move online poker legalization as part of that initiative.

Federal action is a practical imperative for online poker to move forward in the U.S. Operators would obviously prefer a unified set of national regulations over dealing with varied compliance issues at the state and even county level. As online poker would certainly fit within the context of the Commerce Clause, federal action could preempt a significant blue sky issue relating to each state's criminal and banking laws.

Nevada regulators clearly have the jumpstart on this framework. But, at least until federal action happens, there is time for Pennsylvania to catch up.

PLAYING NEW JERSEY'S FOLDED HAND

New Jersey Legislature attempted to get the state out in front earlier this year by adopting a bill that would have legalized only intrastate gambling online. Caesars Entertainment and much of the gaming lobby opposed the bill, with Caesars testifying that a federal solution was the only practical path forward.

New Jersey Gov. Chris Christie vetoed the bill and focused his veto message on the illegality of the measure under both New Jersey's Constitution, which grants special protections to Atlantic City,

and federal law. Other states, including California, Florida and Iowa, are exploring similar intrastate options, and the New Jersey sponsors have pledged to try again. But every intrastate gaming bill appears stalled by the same federal hurdles.

Earlier this month, while regulations are still in draft form (see below), the South Point Casino opened an online poker room, with the blessing of the Nevada Gaming Control Board (NGCB) in late September. In the next few weeks we will see if there are objections from the Department of Justice or from Nevada regulators upset about someone jumping the gun. Given the DOJ's recent actions with respect to medical marijuana in states that had legalized it, it is far from certain that the federal government will allow South Point, or any other intrastate operations, to operate Internet poker.

A GOOD DRAW

In interviews, Michael Gaughan, the owner of South Point Casino was very clear about his intentions. "What I'm trying to [do] is learn," Gaughan said. "I'll probably apply for an intrastate license, and hope to get an interstate license if the Feds ever decide to pass anything."

If online poker is legalized, there would be a tremendous first mover advantage for technology companies, existing online gaming companies and traditional brick-and-mortar casinos, and, along the lines of the Corbett administration push for a new industry in the shale fields for the states.

For example, Caesars Entertainment, with a national reach and a strong presence in almost every gaming market, has already invested heavily in being ready for legalization. Since July 2010, the Caesars's World Series of Poker website has offered free online poker to U.S.-based players (albeit through a company headquartered in Gibraltar). The site has almost all of the functionalities needed for legalized play, except

for the money processing components which presumably are on the shelf. *The Wall Street Journal* estimates that, if legalized, Caesars immediately would capture a 20 percent share of the U.S. market, which is expected to grow to \$5 billion annually.

Noncasino players are making a similar bet. In 2009, Goldman Sachs predicted online poker would be legal in the near future (it has not retracted the prediction, despite the recent crack-down) and identified a handful of technology companies that were already positioned to cash in on online poker legalization through proprietary gaming technology.

THE NEVADA GAMBIT

With their intrastate solution theoretically in place — this was before South Point's announcement last week — Nevada decided to be ready and waiting for the federal government. This spring, the Nevada Legislature authorized online poker regulations and in late August, Nevada regulators made public a new draft regulation, "Regulation 5A," that would govern Internet poker.

The Nevada Gaming Commission intends to have Regulation 5A in place by the end of 2011 for an effective date in early 2012, but the new regulatory regime would only become effective if the federal government formally legalizes online gambling or if the Department of Justice notifies Nevada authorities that "interactive gaming" is permitted under federal law.

It is also unclear whether these regulations will allow South Point and any other intrastate operations to remain in business. At a hearing on Regulation 5A in late September, attorneys representing at least one casino suggested that the board "clarify" that the regulation not permit intrastate gaming before federal legalization is enacted. The comments,

as well as similar comments of lobbyists connected to online poker operators, were taken under advisement.

Regulation 5A imports many of the constructs of brick-and-mortar casinos. Regulators will separately license and monitor each online operator and there will be a process to report and examine any "suspicious wagering." Much like the situation with modern high-technology slot machines, these regulations are only a starting point and the details of the code used will be essential to the development of a robust regulatory environment.

With respect to users, Regulation 5A will limit online poker to those at least 21 years of age. It will require players to use one and only one account — recorded in their own names, enforces self-exclusion rules — and will ban the use of bot technology. In each case, these will be difficult enforcement challenges and there are likely going to be dramatic technological leaps dictated by the compliance efforts to meet the detailed regulations that will follow.

Credit extensions by the online poker operators would be prohibited, but debit and credit card transactions are expressly permitted. This is possible because UIGEA only applies to "illegal gambling" and the triggers in Regulation 5A would ensure that the gambling is legal.

Client funds will have to be held in separate accounts to avoid the apparent problem that Full Tilt is facing. Regulation 5A will also require a deposit with authorities to fund investigations.

These regulations attempt to address head-on the fundamental weakness — a fear of being cheated — that was endemic in the initial spread of online poker. The concerns about a Ponzi scheme at Full Tilt likely will resurrect for some the fears that were overcome

by strong brand identities. The industry has been careful to push for a state regulatory scheme that is fair and friendly to operators, but which will use the credibility of the states to reassure potential customers.

Not only will Nevada license online poker, but it will charge them fees and tax such operations. Everyone involved in the process has been quick to state that the increased oversight will create a significant number of jobs and significant state tax revenue.

HOPING TO CATCH

Nevada regulators clearly have the jumpstart on this framework, and, with Reid's position and influence, they may have some insight on the timing. But, at least until federal action happens, there is time for Pennsylvania to catch up and even move ahead. Given the extent that Pennsylvania, like most states, has liberally borrowed from both Nevada's and New Jersey's gaming regulations, Regulation 5A is likely to be the starting point for any online poker regulations that the Pennsylvania Gaming Control Board were to draft.

Regulatory action alone will not be sufficient for Pennsylvania to catch up. Nevada taxes gaming revenues at a four percent rate, while Pennsylvania taxes poker and other table games at four times that rate — 16 percent.

Online operations have a small physical footprint and can move almost anywhere. If Pennsylvania wants to be a chosen location for online poker operations, the General Assembly might want to quickly adopt a sub-four percent tax rate for online gambling, with similar triggers as appear in Regulation 5A. Pennsylvania has lowered its tax rates for classes of gaming before, as the 16 percent table game rate is about 70 percent lower than the tax rate on slot machines. •