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ONLINE GAMING:
PROHIBITION VS REGULATION

by

Andrew Montgomery

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ABSTRACT

Online Gaming: Prohibition vs. Regulation

by

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Since online gaming began in 1995, the industry has been unsettled. Despite online gaming being viewed as illegal by the United States government, revenues generated from players in the U.S. grew consistently and rapidly from 1995 to 2006. U.S. lawmakers believed they clarified the legality issue by passing the Unlawful Internet Gambling Enforcement Act in 2006 (UIGEA); however, this legislation did little to discourage people in the U.S. from engaging in online gambling. U.S. lawmakers have long debated prohibition vs. regulation of the industry. Given the apparent ineffectiveness of online gaming prohibition via UIGEA, lawmakers favoring legalization and regulation of the industry have gained traction on Capitol Hill. This paper analyzes past legislation that has attempted both prohibition and regulation, and proposed legislation that stands to legalize, regulate, and tax the online gaming industry. This paper describes the proposed legislation, giving future online gaming operators a clear understanding of provisions of the law that must be weighed and considered before entering the industry. Additionally, this paper proposes a regulatory model, slightly different from what is in the proposed legislation, and logic for how this regulatory model more effectively promotes effective regulation of the online gaming industry. This regulatory model would appeal to lawmakers on both sides of the aisle, even those who currently oppose legalization of online gaming.

Table of Contents

Abstract	ii
Table of Contents	iii
Part One	1
Introduction.....	1
Purpose.....	2
Objectives	2
Justification	2
Constraints	4
Part Two.....	5
Introduction.....	5
International Jurisdictions	7
The Wire Act.....	7
Legislative History.....	10
Unlawful Internet Gambling Enforcement Act.....	12
World Trade Organization Dispute.....	15
Legalization/Regulation Legislation	16
Literature Review Conclusion	19
Part Three.....	20
Introduction.....	20
Analysis/Recommendations.....	21
Regulatory Structure	21
Indian Tribe Issues	26
State “Opt-out” Clause.....	27
Political Positioning.....	28
United States vs. Worldwide.....	29
Responsible Gambling	29
Tax Structure.....	30
Competition.....	33
Conclusion	33
Reference List	35

Part One

Introduction

The online gaming industry has seen rapid growth in its short lifespan. Online gaming first emerged as a leisure activity for people in the mid 1990's. The first online gaming website launched in August 1995 and it is estimated there are currently over 2,000 online gaming sites (American Gaming Association, 2010a). Many of these sites operate out of the island nation of Antigua and Barbuda, which licenses online gaming operators (Kelly, 2006).

The online gaming industry's life in the United States has been characterized by governmental and regulatory indecision. From 1995 to 2006, the U.S. Department of Justice maintained the position that online gaming was an illegal enterprise; however, few attempts were made by authorities to actually combat the growing industry (Rose, 2006). The number of United States residents participating in online gaming, and revenue generated from online gaming, skyrocketed during this time period (Holliday, Kelleher, Bradbury, & Crompton, 2010).

Between 1995 and 2006 Republican legislators made several attempts to pass online gaming prohibition; which would have cemented the Department of Justice's position. Until 2006, none of these attempts were successful. In 2006, the Unlawful Internet Gambling Enforcement Act (UIGEA) was passed by the U.S. Congress and signed into law by President Bush (H.R. 4954). This legislation did little to stop people in the U.S. from participating in online gaming. Given the popularity of online gaming and the government's inability to effectively enforce UIGEA, Congressman Barney Frank (D-MA) introduced legislation to legalize online gaming in 2009. This legislation, titled the Internet Gambling Regulation, Consumer Protection, and Enforcement Act of 2009, proposes a system to license and regulate online gaming. The bill was amended and passed a vote in the House Financial Services

Committee on July 29, 2010. It is not currently scheduled in 2010 for a vote by the House of Representatives (Internet Gambling Regulation, Consumer Protection, and Enforcement Act, 2009). Other similar bills have also been drafted on Capitol Hill, but not yet introduced for committee review.

Purpose

The purpose of this professional paper is to analyze the situation regarding United States online gaming public policy and how proposed federal legislation could change the landscape of the online gaming industry as of October 31, 2010.

Objectives

This analysis and subsequent recommendations will provide a framework for gaming operators should the proposed legislation become law. In addition, the analysis will include political issues associated with the passing of the legislation. These issues include liberal and conservative viewpoints and potential future developments of the online gaming industry, based on changes in the political landscape. Finally, the analysis will cover proposed regulation, and recommendations for regulations to best avoid potential pitfalls for the industry.

Justification

To properly understand the future of gaming, an in-depth knowledge of online gaming is critical. Many traditional casino operators, such as Harrah's Entertainment, Las Vegas Sands, Wynn Resorts, and MGM Resorts International, will be affected by online gaming, whether positively or negatively, in the future. It is important for these companies to prepare for, and adapt to, developments in online gaming policy. In its current form, online gaming is acting as a competitor to traditional casinos. But since it is illegal in the U.S., casino companies cannot enter this market for fear of running afoul of government regulators who issue licenses in various

jurisdictions around the country. The Department of Justice's actions are, effectively, protecting illegal online casino operators from competition from legitimate casino operators in the online marketplace. These legitimate casino operators understand the vast, lucrative market that is online gaming, and therefore, are lobbying for its legalization and regulation. This would, if done correctly, eliminate companies currently acting illegally from involvement in a legalized online gaming industry in the U.S (Benston, 2010).

U.S. Casino operators have begun working to set up online platforms to enter the online gaming industry should the proposed legislation become law. Online gaming can offer these companies an opportunity to expand their casino empires. It is, and will continue to be, important for these casino companies to understand the atmosphere on Capitol Hill and how future political developments will affect online gaming legislation and potential future regulation of the industry.

Online gaming legislation has been a political issue on Capitol Hill for over a decade. Despite the U.S. Department of Justice's position that the industry was illegal, legislators recognized the need to pass legislation, solidifying this position. Despite UIGEA being passed, the future of the industry remains in question. While the issue has taken a backseat on Capitol Hill to more pressing legislative initiatives such as financial reform legislation and health care legislation, online gaming remains critical to many people and states, including, of course, Nevada. Moreover, the proposed legalization has clear implications for the U.S. economy. Offshore online gaming companies brought in \$5.1 billion in revenue from the United States in 2009 (Holliday et al., 2010). If this industry is properly regulated and taxed, these online gaming revenues could provide a tax windfall for the federal and state governments. Policymakers must understand the macroeconomic impact of legalized and regulated online gaming. Knowledge of

online gaming is important both from the standpoint of individual companies looking to take advantage of a growing industry and from a public policy standpoint.

Constraints

The recommendations for how to implement regulation of online gaming will focus on legislation sponsored by Congressman Barney Frank, which passed through the House Financial Services Committee in July 2010. Though this paper is being completed as staffs of several members of Congress are drafting legislation regarding online gaming, these drafts have not been submitted for committee review and are not public.

This subject is dependent on many political forces, which change on a constant basis. The current political landscape, as of October 2010 will be discussed. Potential changes, and how those changes will affect the subject matter will also be discussed; however, it is important to note the author is not certain of future political developments that could affect the subject matter.

Part Two

Introduction

Part One presented an overview of the online gaming industry and legislation that is poised to legalize the industry in the United States. The need for casino operators to understand the legislative history and be prepared for future legislative developments was also discussed. Part Two presents a history of online gaming and the history of legislation regarding the topic. Literature written about the topic at different stages in the industry's life is used to present this history.

Table 1 presents major legislation introduced regarding online gaming. Several of these bills are discussed in detail in the following sections.

Table 1

Online Gaming Legislation

Year Introduced	Bill Number	Title
1995	N/A	Internet Gambling Prohibition Act
1997	S. 474	Internet Gambling Prohibition Act of 1997
1998	S. 2260	Internet Gambling Prohibition Act of 1998
1998	H.R. 4350	Internet Gambling Prohibition Act of 1998
1998	H.R. 4427	Internet Gambling Prohibition Act of 1998
1999	S. 692	Internet Gambling Prohibition Act of 1999
2000	H.R. 3125	Internet Gambling Prohibition Act of 2000
2000	H.R. 5020	Comprehensive Internet Gambling Prohibition Act of 2000
2000	H.R. 4419	Unlawful Internet Gambling Funding Prohibition Act
2001	H.R. 556	Leach-Lafalce Internet Gambling Enforcement Act
2002	S. 3006	Comprehensive Internet Gambling Prohibition Act of 2002
2005	H.R. 4411	Unlawful Internet Gambling Enforcement Act
2006	H.R. 4777	Internet Gambling Prohibition Act
2007	H.R. 2046	Internet Gambling Regulation and Enforcement Act of 2007
2007	H.R. 2607	Internet Gambling Regulation and Tax Enforcement Act of 2007
2009	H.R. 2267	Internet Gambling Regulation, Consumer Protection, and Enforcement Act
2009	H.R. 2268	Internet Gambling Regulation and Tax Enforcement Act of 2009
2009	S. 1597	Internet Poker and Game of Skill Regulation, Consumer

The first online gaming website was launched in August 1995 (American Gaming Association, 2010a). Since this launch, the industry has seen unprecedented market growth. Estimates of the true size of the industry vary; however, in 2006 most estimates of online gaming revenue ranged from \$10 billion to \$12 billion annually (Cotte & Latour, 2009). By 2009, worldwide online gaming revenues grew to \$25.8 billion, with \$5.1 billion of that revenue coming from the United States; despite the October 2006 passage of the Unlawful Internet Gambling Enforcement Act (UIGEA) (American Gaming Association, 2010a; Holliday et al., 2010; H.R. 4954).

Many experts predicted the passage of UIGEA in 2006 would hurt the online gaming industry. In 2007, UK-based Global Betting and Gaming Consultants projected worldwide industry revenues would decrease by over \$4 billion in 2007, and continue at this depressed rate through 2010. That study projected worldwide online gaming revenue in 2009 to be \$18.4 billion (“Study: U.S. ban”, 2007). UIGEA has not had this effect on the worldwide industry. In 2009, worldwide online gaming revenue was \$25.8 billion (American Gaming Association, 2010a).

Online gaming revenue generated from players in the U.S. did decline, briefly, in 2007 after the passage of UIGEA. In 2006, online gaming revenue generated by U.S. players was \$6 billion. This number decreased to \$4 billion in 2007, as players were uncertain about legal issues. This depression was, however, short-lived. Online gaming revenues from U.S. customers rose in 2008, to 5.0 billion, and 2009, to 5.1 billion despite the recession, which caused overall U.S. gaming industry revenues to fall in 2009 (Holliday et al., 2010).

International Jurisdictions

Throughout the history of the online gaming industry, many countries around the world have recognized its legality. This list includes the Caribbean island nation of Antigua-Barbuda, Australia, and European Union countries. Antigua has become one of the most popular locations for operators of online gaming websites. In 1994, Antigua passed the Antigua and Barbuda Free Trade and Processing Zone Act. This act required the Antiguan government to create a “tax-free” zone for a number of industries, to encourage international investment on the small island. Online gaming was one such industry. Antigua has attracted vast international business by creating tax havens, due to this law. Internet gaming operators found such a haven in Antigua, which provided a business atmosphere in which their industry was licensed (Andrle, 2006).

While applicants for gaming licenses in Antigua are subject to background checks, the international community believed online gaming operators were subject to little accountability by the Antiguan government. Antigua responded to these concerns by enacting regulations, further tightening governmental controls of the country’s growing online gaming industry. These controls did little to convince other countries that Antigua was serious about policing the online gaming industry. The international perception that Antigua is a loose business environment with little to no regulation of the online gaming industry is unlikely to change (Andrle, 2006). The legality of online gaming in Antigua and its illegality in the United States eventually led to a World Trade Organization Dispute between the two countries (Wohl, 2009).

The Wire Act

Despite the recognized legality of online gaming in many nations, the United States Department of Justice has taken the position that online gaming is illegal. To justify this hard-line stance against internet gaming, the Department of Justice cites the *Wire Act*, which was

passed by Congress in 1961. The law was passed in response to the growing problem of organized crime in America. The target of the *Wire Act* was illegal bookies taking bets on sporting events via telephone (Rose, 2006). The crux of the *Wire Act* is the following:

Whoever being engaged in the business of betting or wagering knowingly uses a wire communication facility for the transmission in interstate or foreign commerce of bets or wagers or information assisting in the placing of bets or wagers on any sporting event or contest, or for the transmission of a wire communication which entitles the recipient to receive money or credit as a result of bets or wagers, or for information assisting in the placing of bets or wagers, shall be fined under this title or imprisoned not more than two years, or both. (*Wire Act*, 1961, sec. a)

Critics of the position taken by the Department of Justice contend the law was aimed at organized crime organizations, and not meant for people participating in online gaming (Andrle, 2006; Rose, 2006). As the *Wire Act* was written and passed in 1961, long before the internet existed, critics argue that it is impossible for the law to pertain to internet gaming (Rose, 2006).

Several courts have considered the legal question of whether or not the *Wire Act* applies to online gaming. In what appeared to be a major victory for online gaming advocates, the U.S. District Court in Louisiana ruled that a claim against MasterCard and Visa, which charged that the financial companies were in the business of online gaming because the companies transferred money electronically to online casino operations, was unfounded. Many observers, including the legislature of the State of Nevada, took this as a precedent establishing the legality of online gaming. The Nevada Legislature passed a bill in 2001 requiring the Nevada Gaming Commission to study the feasibility of online gaming in the state. In response to this bill, the Department of Justice sent Nevada a letter stating its opposition to the U.S. District Court's ruling and reiterating its continued position that online gaming was covered by the *Wire Act*. In addition, the Department of

Justice threatened to file charges against anyone participating in any form of online gaming, including Nevada casino operators (Rose, 2006).

When prosecuting online gaming operators, the Department of Justice usually invokes the *Wire Act*; however, the 1961 *Travel Act* and the 1970 *Illegal Gambling Business Act* can also be used for prosecutions. These laws are quite broad in scope; therefore, prosecutors rarely use them individually (Andrle, 2006).

The most famous prosecution of an internet gaming operator occurred when Jay Cohen, a partner in World Sports Exchange, a sports gaming operation licensed in Antigua, was found guilty of violating the *Wire Act*. Cohen was sentenced to 21 months in jail. This case established precedent that the *Wire Act* could successfully be used to prosecute online sports betting operations; however, the applicability of the *Wire Act* to other forms of online gaming remained unclear. In fact, the Federal Appellate court ruled in the above-mentioned MasterCard and Visa case, that the *Wire Act* does not prohibit non-sports online gaming (Kelly, 2006).

This ruling did not change the Justice Department's position (Kelly, 2009). Despite the Department of Justice's staunch position regarding online gaming, Congress recognized the ambiguity of the issue and the need for clarification. Some members of Congress believed internet gaming should be made legal and regulated; while others believed an outright prohibition was preferable. Those in favor of prohibition generally cite researchers who have speculated that risk of addiction to online gaming is greater than that of traditional casino gambling (Cotte & Latour, 2009). In addition, they argue that enforcement of limits on internet gaming, especially age restrictions, will be problematic. They also argue that internet gaming fosters consumer fraud and provides a

possible avenue for money laundering (Congressional Research Service, 1998).

Proponents of legalizing and regulating online gaming generally cite the tax benefits and the inability to effectively enforce prohibition as their primary reasons for regulation.

Legislative History

Jon Kyl, a conservative Republican senator from Arizona, was one of the first legislators to push to outlaw online gaming. Kyl's first attempt at doing so was the Internet Gambling Prohibition Act of 1995 (Rose, 2006). Kyl proposed this bill as an amendment to the Crime Prevention Act of 1995, a bill that had nothing to do with online gaming. This would be a telling sign. Eleven years later legislators would finally push through legislation prohibiting online gaming as a last minute addition to a broader security bill that had nothing to do with internet gaming (Rose, 2007).

This 11-year lapse was not for lack of effort by Senator Kyl or several of his Republican colleagues in the Senate and House of Representatives. In 1998, the Senate passed the Internet Gambling Prohibition Act of 1998 (sponsored by Senator Kyl) as an amendment to The Commerce, Justice, and State Appropriations Bill. Two of Kyl's allies in the House of Representatives, Congressman Robert Goodlatte and Congressman Frank LoBiondo, both conservative Republicans, introduced a companion bill in the House of Representatives. This bill was submitted to the House of Representatives, but was never voted on; therefore, despite the Senate passing the Internet Gambling Prohibition Act, the bill never became law (Congressional Research Service, 1998).

Senator Kyl continued his crusade the following year, in the 106th Congress. Again, the Senate passed the Internet Gambling Prohibition Act of 1999. This version was less ambitious than previous bills introduced by Kyl. Specifically, this bill did not

set out provisions for criminal punishments for individual bettors. Rather, it would punish only the operators of online gaming sites (Andrle, 2006). Congressman Goodlatte introduced a similar bill, with the same name. The bill was successfully voted out of the House Judiciary Committee; however, it was voted down by the full House of Representatives (Congressional Research Service, 2001). These bills would have outlawed “commercial use of the internet to gamble or facilitate gambling” (Congressional Research Service, 2001, p. 1).

Interestingly, several Republican Congressmen broke with their party and opposed this bill. While unclear at the time to observers, Jack Abramoff, a Washington D.C. lobbyist effectively killed the bill (Schmidt & Grimaldi, 2005). Abramoff was representing eLottery, Inc., a client that wanted to sell state lottery tickets online. If these bills completely prohibiting online gaming were passed, Abramoff’s client would be out of business. Abramoff had close ties to the Republican Party; then majority leader Tom Delay (R-TX) referred to Abramoff as “one of my closest and dearest friends” (Harding, 2005). Abramoff convinced several members of the Republican Party to oppose the bill. It was later proven that Abramoff secured many of these votes with lavish trips for the lawmakers (Schmidt & Grimaldi, 2005). Abramoff later pled guilty to corrupting public officials (Schmidt & Grimaldi, 2006).

Similar bills were introduced in the 107th and 108th Congresses. These bills were sponsored by Senator Kyl, Congressman Goodlatte, and Congressman Jim Leach, another conservative Republican. These bills all had the same intended purpose; however, they went about achieving their goals differently. Some sought to outlaw internet gaming by making it illegal for operators to operate. Others proposed making it

illegal for players to play. Some simply sought to clarify the *Wire Act* to include online gaming as an activity that was strictly prohibited. Finally, conservative legislators proposed attacking the issue from a financial payment angle (Congressional Research Service, 2001).

Unlawful Internet Gambling Enforcement Act

On October 13, 2006, President Bush signed the Security and Accountability for Every Port Act (SAFE Port Act) into law (H.R. 4954). This bill was passed in the final minutes of the last day of the 109th Congress, before legislators returned to their respective districts to run for reelection (Rose, 2007). The SAFE Port Act requires, among other things, that imported containers travelling through U.S. ports be scanned for radiation and additional measures be taken dealing with security of ports from a terrorist attack (Malone, 2006). So, why do we care about the SAFE Port Act when studying online gaming?

The SAFE Port Act is at the center of the online gaming debate because UIGEA was attached as Title VIII of the SAFE Port Act at the last minute. The versions of the SAFE Port Act passed by the house on May 4, 2006 (by a vote of 421-2) and the Senate on September 14, 2006 (by a vote of 98-0) contained no language related to internet gaming. Members of the House and Senate got together, after the initial vote, in conference to make changes to each respective body's versions of the SAFE Port Act. During conference, UIGEA was added to the bill. The reading of the conference report was waived and the House passed the final version by a vote of 409-2 and the Senate by a unanimous consent motion (H.R. 4954). According to Senator Frank Lautenberg of New Jersey, nobody on the conference committee had read the final language. It is clear many members did not know what was in the final bill (Kelly, 2009; Rose, 2007).

At this point, it is important to understand the political atmosphere on Capitol Hill in the summer and fall of 2006. Republicans had controlled both houses of Congress since 1994. The party was plagued by rumors of corruption, and news organizations and polls were reporting they could lose their majorities in both houses of Congress (Election, 2006). Most of the allegations of corruption centered around one lobbyist, Jack Abramoff. Fearing defeat, Republicans decided to campaign on social issues to energize the base of their party. In 2006, conservative legislators unveiled their American Values Agenda. This included ten points of party values. Included on these ten points was the prohibition of internet gaming. Other values listed were typical right-wing social values issues such as a ban on gay marriage and a ban on stem cell research (Preston, 2006).

Unfortunately for online gaming, the industry became a poster child for the Jack Abramoff scandal (Schmidt & Grimaldi, 2005). Abramoff pled guilty in January 2006 to corruption charges (Schmidt & Grimaldi, 2006). In the summer of 2006, as Republicans feared of losing control of both the House and the Senate, the Abramoff scandal was fresh on the minds of voters. Republican lawmakers in tough re-election contests recognized the need to appear anti-corruption and to distance themselves from the Abramoff scandal as much as possible (Weisman, 2006). It was, therefore, convenient to include the prohibition of online gaming as part of their American Values Agenda. This would place Republican legislators in opposition to Abramoff and advance a policy that many Republicans had favored for 11 years.

Specifically, UIGEA attempts to strangle the online gaming industry by cutting off the flow of revenue from the United States to online gaming businesses. The rationale is that if offshore internet gaming companies cannot receive payments from the United States, the companies will withdraw from the United States market (Kelly, 2009). UIGEA prohibits

gambling-related businesses from accepting all forms of payments to be used in conjunction with online gaming. UIGEA specifically applies to anyone engaged in the business of betting, or wagering. This definition; however, specifically excludes financial institutions that may be used in connection with a transfer of funds (Congressional Research Service, 2009). This, effectively, removed any teeth the bill had with respect to holding financial institutions responsible for ensuring money is not transferred to offshore online gaming operators.

Critics of UIGEA have argued the law is vague, leaving key legal questions unanswered. In fact, critics of the law and proponents of online gaming contend UIGEA did not make anything illegal that was not already illegal according to the Department of Justice (Kelly, 2009). UIGEA's definition of "unlawful internet gambling" does not specify what types of gambling are illegal; rather the statute gives deference to underlying individual state laws.

The Interactive Media Entertainment & Gaming Association filed a lawsuit alleging UIGEA was unconstitutional because of its vagueness, specifically due to the lack of an "ascertainable and workable definition" of the statutory phrase "unlawful internet gambling" (Congressional Research Service, 2009, p. 3). The U.S. Court of Appeals ruled against the Interactive Media Entertainment & Gaming Association. Specifically, the appellate court ruled UIGEA "itself does not make any gambling activity illegal...to the extent there is a vagueness problem, it is not with the Act, but rather with the underlying state law" (Congressional Research Service, 2009, p.3). This further muddied the waters of what was legal, and what was illegal, based on UIGEA.

UIGEA defines "bet or wager" as "the staking or risking by any person of something of value upon the outcome of a contest of others, a sporting event, or a game subject to chance, upon an agreement of understanding that the person or another person will receive something of

value in the event of a certain outcome” (Congressional Research Service, 2009, p. 2). The Justice Department recognized this ambiguity posed a problem. Bruce Ohr, Chief of the Organized Crime and Racketeering Section of the Department of Justice, raised concerns to Congress about whether UIGEA sufficiently covered card games such as poker (Congressional Research Service, 2006). This opened the door for professional poker players and the Poker Players Alliance, a lobbying group formed by poker players, to claim UIGEA should not apply to poker because poker is a game of skill, not a game predominately subject to chance (Cypra, 2009a).

World Trade Organization Dispute

The Department of Justice’s hard-line stance against online gaming led to a well-publicized World Trade Organization (WTO) dispute between the United States and Antigua. The WTO is an international body that facilitates and regulates international trade. In 2003, Antigua initiated the WTO dispute resolution process, claiming the United States violated the General Agreements on Trade and Services (GATS) by prohibiting online gaming (Faust, 2005). GATS is an international treaty to encourage WTO members to trade in things other than tangible products. Antigua claimed internet gaming was a service; therefore, the United States ban on the industry was a violation of GATS (Kelly, 2006). This was a David vs. Goliath-type battle. The United States was, and is, one of the most powerful members of the WTO, whereas, Antigua was an island nation with approximately 69,500 residents as of 2007, and less than 443 square miles of land (Wohl, 2009).

In support of its claim, Antigua contended that the *Wire Act*, *Travel Act*, and *Anti-Gambling Business Act* and over a hundred other federal and state measures violated GATS (Kelly, 2006). In 2004, a dispute resolution panel ruled in Antigua’s favor. The United States

filed an appeal with the WTO claiming, among other defenses, that the country was morally opposed to online gaming. This moral clause was traditionally reserved for religious concerns, such as Muslim nations not engaging in the free trade of alcohol. On appeal, the moral clause defense was rejected, and the original ruling was upheld (Wohl, 2009).

The WTO ruling required the United States to change its laws to not be in violation of GATS. In 2007, a WTO compliance panel found the United States was not in compliance with the body's decision. Rather than change its laws and positions with regards to online gaming, the United States proceeded to withdraw from its commitments under GATS. Because of this withdrawal, the U.S. was required to compensate any countries affected. Australia, Canada, Costa Rica, the European Union, India, Japan, and Macao filed claims against the U.S., citing financial damage because of the United States's withdrawal from its requirements under GATS (Wohl, 2009). The Bush administration quietly settled claims with several of these countries. Requests were made both by the press and members of Congress for disclosure of the settlement agreements. The Bush administration would not comply with the *Freedom of Information Act*, which required the administration to disclose the settlements (Polson, 2008b). In its refusal, the administration cited "national security" as their reason for refusing to comply with the request. In a letter to the administration, Congressman Barney Frank implied that denial of the request appeared to be a political decision to not reveal information that would be viewed unfavorably by the public (Polson, 2008a).

Legalization/Regulation Legislation

This was not the first time Congressman Frank has weighed in on the online gaming issue. Congressman Frank is a notoriously outspoken liberal from Massachusetts and a proponent of legalizing and regulating online gaming. On April 26, 2007, Frank introduced the

Internet Gambling Regulation and Enforcement Act (House Financial Services Press Release, 2007). This bill sought to overturn UIGEA and set up a regulatory system to license internet gaming operators in the United States. A companion bill was sponsored by Congressman Jim McDermott, a Democrat from Washington (Cypra, 2009b). Both these bills were sent to committee, but no action was taken. Congressmen Frank and McDermott would prove to be the Democratic answer to Senator Kyl and Congressmen Goodlatte and Leach.

Congressman's Frank's position is that complete prohibition of online gaming does not combat the growing industry; rather it leaves consumers vulnerable to fraudulent practices. There are also no safeguards to protect against underage gambling and compulsive gambling. This bill sought to regulate internet gaming to solve these problems (House Financial Services Committee Press Release, 2007). Frank also believes that a complete prohibition of internet gambling is an interference with personal freedoms and liberties of citizens. According to Frank, "The existing legislation is an inappropriate interference on the personal freedom of Americans and this interference should be undone" (House Financial Services Committee Press Release, 2007, p. 1).

Despite the defeat of this bill in committee, Congressmen Frank and McDermott continued their fight to repeal UIGEA and legalize online gaming. On May 6, 2009, Frank introduced The Internet Gambling Regulation, Consumer Protection, and Enforcement Act. The bill was debated and amended on July 29, 2010 in the House Financial Services Committee, which is chaired by Congressman Frank (Batt, 2010). The bill was voted favorably out of committee, by a vote of 41-22. The bill received some bipartisan support; however, the vote fell primarily along party lines with Democrats voting for the bill and Republicans opposing the bill (Batt, 2010). Despite this favorable vote, Congressman Frank is realistic about the bill's chances

of being brought to a vote on the House floor before the November 2010 Congressional elections. Time is short for passing new legislation as lawmakers focus on campaigning during election season (Batt, 2010).

At this point, it is important to understand the political atmosphere on Capitol Hill in the summer and fall of 2010. The Democrats currently find themselves in the exact same position as Republicans in the summer of 2006. In 2006, polls and media reports speculated that Republicans would lose control of both houses of Congress (Election, 2006). In 2010, polls and media reports speculate that Democrats will lose control of both houses of Congress (Newport, 2010). In 2006, Republicans faced enthusiastic opposition from Democratic voters because of controversial policies of the Bush administration and the Republican Congress, including the wars in Iraq and Afghanistan. In 2010, Democrats face enthusiastic opposition from Republican voters because of controversial policies of the Obama administration and the Democratic Congress, including the health-care reform law and the stimulus bill. It is an understatement to say the political atmosphere is divisive on Capitol Hill at the current time (Gardner, Thompson & Rucker, 2010).

Due to this political environment, Congress has many important decisions to make prior to the November elections and also during the lame duck period, from the November elections to when new Senators and Representatives will take office in January. These policy decisions include measures much more important to the general public than online gaming legislation, such as whether to extend tax cuts passed by the Bush administration (Gale, 2010). The current political climate makes it difficult to hold votes on controversial issues (Batt, 2010).

Congressman Frank has been realistic and realizes that his bill is unlikely to be brought to the floor before the November 2010 elections. It is, of course, possible that the bill could be passed

the same way UIGEA was passed, by attaching it to a larger, more popular bill. While Congressman Frank has stated his opposition to this approach, nothing is off the table (Batt, 2010).

Congressman McDermott's companion bill, the Internet Gambling Regulation and Tax Enforcement Act of 2009, was originally introduced on May 6, 2009. An identical bill, with the same name, was re-introduced on March 25, 2010. The bill has been referred to the House Ways and Means Committee, where it is awaiting debate and a vote. This bill primarily focuses on the tax structure of a legalized online gaming industry (Batt, 2010).

Literature Review Conclusion

As this section illustrated, the question of legality surrounding online gaming has been contentious since the industry exploded into the public's consciousness in 1995. Many legislators have taken up the cause to clarify this question, both from a prohibition standpoint and a regulation standpoint. UIGEA, passed in 2006, was supposed to answer the question once and for all; however, it has failed to do so. Congressman Barney Frank's bill attempts to clear the waters by legalizing and regulating the industry. One thing is for certain, whether Frank's bill is successful or not, online gaming operators are alive and well outside the United States. UIGEA has done little to stem gambling online by U.S. residents. Whether prohibited or not, online gaming is here to stay.

Part three will focus on details of Congressman Frank's bill, suggestions for enforcing the bill and regulating the online gaming industry, and recommendations for gaming operators to adapt to changing legislation and a changing political environment.

Part Three

Introduction

Part two presented a history of online gaming legislation in the United States. This legislation, particularly UIGEA, changed the online gaming industry. The regulations developed for complying with UIGEA went into effect in July 2010 (Kredell, 2010). The gaming industry consensus is that the law and its regulations did not do much to stop online gaming. Given this, it is clear that complete prohibition does not eliminate online gaming. Online operators, operating outside U.S. law enforcement jurisdiction, continue to offer games, and players within the U.S. continue to play. The only parties losing in the current situation are the federal and state governments, who do not collect tax revenue from the industry.

Part three will analyze the Internet Gambling Regulation, Consumer Protection, and Enforcement Act (Frank Bill), present ways to improve the bill, and describe a regulatory framework for properly regulating and taxing online gaming. This section will present important aspects of the bill that potential online gaming operators must be aware of and consider when making decisions. This new legal and regulatory schema, if implemented properly, will allow U.S. casino operators to expand their businesses and allow federal and state governments to collect much-needed tax revenue.

Ideas for the online gaming regulatory and tax structure presented in this section are a compilation of ideas drawn from the author's personal experience as a gaming regulator and interviews with casino executives and congressional staff working on crafting online gaming legislation.

Analysis/Recommendations

All the legislation presented in Part Two contributed, in some way, to the current state of the online gaming industry. The Frank Bill is a reaction to this current state. Most online gaming websites operating offshore offer several different forms of gaming including poker, traditional casino games, and sports wagering. The Frank Bill does not differentiate between these different forms of gambling, except to say that no bets will be taken on sporting events.

Despite the fact the bill does not address which specific forms of gambling would be legalized for play on the internet, gaming executives believe no bets should be accepted on slots or traditional casino games via the internet. These executives believe to have any chance of passing the House and Senate; a final bill will clearly stipulate online poker is the only form of legalized online gaming.

Based on language in the Frank bill, any company that has intentionally violated U.S. law will not be eligible for an online gaming license. This eliminates all offshore companies that are in violation of UIGEA. In an interesting maneuver, offshore online gaming companies who are currently making financial transactions illegally, pursuant to UIGEA, are lobbying for all forms of gambling to be included in new online gaming legislation. Those companies believe if the legislation to legalize online gaming includes all forms of gaming, it will not have enough support to be voted into law. Those companies are fearful online poker legislation will hurt their companies by opening the market to U.S. casino operators. Their method to kill online poker legislation is to include all forms of gambling in the legislation.

Regulatory Structure

The Frank Bill outlines guidelines for regulating the online gaming industry and instructs the Secretary of the Treasury to prescribe regulations necessary to administer and enforce the

guidelines. The Treasury Secretary would have full responsibility over the licensing and regulation of the United States online gaming industry. Current Nevada gaming regulators and casino industry executives believe that giving the Treasury department this responsibility is a mistake. The United States government does not have a federal gaming regulatory agency. At no time in the country's history has any agency within the federal government been exposed on gaming, or the regulation of gaming. Rather, many individual states have a long history of regulating the gaming industry within their borders. In many instances, these states have been successful at eliminating criminal influence on the industry, and shepherded the industry to remarkable periods of growth. Given this history, the federal government should not regulate online gaming; rather, the industry should be regulated by individual states that have established track records of regulating the gaming industry. This is not to say that the regulation of the entire industry should be turned over to one state. A regulatory model should be implemented given fair consideration to each state that has a proven track record showing it can effectively regulate gaming. How to determine which states should qualify to regulate the industry is a political question and will be addressed later in this section.

The Frank Bill does have a provision in which states and tribal regulatory bodies can notify the Treasury Secretary of their willingness to review potential online gaming operators. This provision does not require that the state receive any tax revenue or economic advantage by participating. The bill mentions the state may impose an administrative fee upon the online gaming license applicant. This is not much of an economic incentive for the states. Within the regulatory structure I am proposing, qualified states will automatically receive a percentage of tax revenue from the industry. This will be discussed further later in this section.

The U.S. Treasury Department is primarily responsible for maintaining a strong domestic economy and creating economic vitality by strengthening the job market and creating economic opportunities. Needless to say, this is a vitally important function, especially given the current state of the domestic economy. Giving the Treasury Department another responsibility, which is clearly of less importance than improving the domestic economy, would not be wise. The proper attention will not be paid to the regulation of online gaming. As Nevada gaming regulators can attest, if gaming is not regulated on a full-time basis, the industry is ripe for crimes including money laundering, financial fraud, and underage gambling.

Furthermore, as discussed in Part Two, the country is much divided politically. The Republicans are set to make large gains in the Senate and the House of Representatives in the 2010 mid-term elections (Newport, 2010). This Republican support is, in part, because people are upset about the increasing federal deficit. Republicans are considered the fiscally conservative party. They campaign on platforms of curbing federal spending and decreasing the size of federal government. While they have not actually followed through on decreasing the size of federal government in past, given the current political discourse, it is safe to assume there will be a push to decrease the size and scope of the federal government over the next two years. It will, therefore, be difficult politically to pass legislation that creates additional responsibilities for federal agencies, especially the Treasury Department.

Rather than leave the regulatory responsibility to the Treasury Department, the bill would be wise to leave regulatory responsibilities to individual states, called “qualified states.” The Secretary of the Treasury would, in essence, delegate responsibilities for the full-time regulation and enforcement of the industry to these qualified states. This has several advantages beyond being politically palatable to both parties. Many individual states have some experience

regulating gaming on some level; the federal government does not. This level of experience is an important factor in determining which states will be qualified.

Which states would be given the right to license and regulate online gaming is a political question. The obvious, most important qualification would be that a state must have a full time Gaming Control Board and/or Gaming Commission and have the staff capacity, experience, and expertise to establish internal control policies to effectively regulate the online gaming operators who set up shop within that state's border. By setting up operations within a specific state, the company will be choosing to be regulated by that state. For example, an online gaming operator that sets up their internet servers in Nevada would be regulated by Nevada. To ensure the state has the ability to be effective regulators, it must show it can handle the volume of play that online gaming will generate. Online gaming revenue in the U.S. in 2009 was \$5.1 billion, and this was while the industry was illegal in the United States (American Gaming Association, 2010a). If the industry is legalized, major U.S. casino operators will enter the market and spend millions of dollars marketing their brands to U.S. players. The industry will only grow. Qualified states must be able to handle regulating an industry of this size.

A gaming revenue threshold should be established whereby the only states that have gaming industries currently exceeding that threshold can be qualified. This ensures the states have adequate resources to regulate a large gaming industry. This is where politics enters the picture. As members of the House of Representatives and Senate are elected to represent their constituents' interests, they all want their states included in legislation that will have economic benefits. This is especially important in partisan legislation that is in danger of not having enough votes to pass. For instance, two moderate Republicans who have shown a willingness to break from their party on controversial legislation in the past two years are Olympia Snowe and

Susan Collins, both of Maine. Maine, however, would not meet any reasonable revenue threshold as it only has one commercial gaming enterprise, a racino in Bangor. Senators Snowe and Collins would be unlikely to break from their party to support legislation that would not include Maine as a qualified state.

Some gaming executives have suggested a revenue threshold of \$3 billion gross gaming revenue. This means the state's gaming industry must have produced gross gaming revenue of at least \$3 billion in the past year. This is politically difficult as it would exclude every state except for Nevada and New Jersey. Nevada and New Jersey have two of the most well-known and effective regulatory structures, the Nevada Gaming Control Board/Nevada Gaming Commission and the New Jersey Casino Control Commission/New Jersey Division of Gaming Enforcement, respectively. It is more likely the gaming revenue threshold would be \$2 billion, or even \$1 billion. Based on 2009 figures, at a \$2 billion revenue threshold, in addition to Nevada and New Jersey, Indiana, Louisiana, and Mississippi would be included. At \$1 billion, Illinois, Pennsylvania, Missouri, Michigan, Iowa, and Kansas would also be included (American Gaming Association, 2010b).

While lowering the threshold makes the legislation more politically palatable, it could, potentially, create a situation where the states compete against each other by offering less regulation. As the tax rate will be federally mandated, the states will not be a position to offer tax breaks to attract business to their state. Rather, they will attract business with less stringent regulatory environments. If one state lowers its regulatory requirements, companies will choose that state to set up their online gaming businesses. Other states will respond by lowering their regulatory requirements. This will create a "race-to-the-bottom" from a regulatory standpoint. A higher gaming revenue threshold will decrease the number of states and decrease this problem.

To completely eliminate this problem, the Treasury Department must establish minimum requirements for each qualified state to follow, even though regulation will be the responsibilities of the individual qualified states.

Indian Tribe Issues

Another issue that must be addressed in determining a regulatory structure is the role of Indian tribes. The Frank Bill requires tribes be consulted regarding any aspect of the legislation that will affect the tribe. This is quite vague. If each individual tribe is allowed to host an online gaming website, and not subject to the same regulatory requirements, the “race-to-the-bottom” will be accelerated and tribes will have a competitive advantage over operators subject to more stringent regulatory requirements of qualified states.

Indian tribes have been enriched by gaming and have become influential on Capitol Hill. Ideally, tribal bodies would be treated as individual states. This would mean if the tribal body does not meet the gaming revenue threshold, the tribal body would not qualify to host online gaming. This is considered politically impossible, however. To agree not to participate in online gaming, tribes would need to be compensated in some way. This could also, potentially, cause problems.

According to several industry executives, their biggest concern is a legal challenge from an individual tribe. If legislation eliminating tribes from participation is passed with the agreement of tribal bodies, the major U.S. casino operators (MGM, Harrah’s, etc.) will pour hundreds of millions into this industry to launch their brands on the internet. If one individual tribe decides it does not like the agreement and challenges the agreement in court, the industry could be opened to all tribes quickly if a judge rules in favor of the one tribe. The major

operators would then have invested a large amount of capital with the understanding they were insulated from tribal competition, but this would no longer be the case.

State “Opt-out” Clause

Another potential problem for online gaming operators is the “opt-out” clause in the Frank Bill. The Frank Bill provides the right to the governors of individual states to opt-out of online gaming. This opt-out would eliminate the individual state from participation in the Frank Bill, effectively keeping online gaming illegal in the state. So, despite the bill being debated and amended by 100 Senators and 435 members of the House of Representatives, any one governor can completely derail the legislation in his or her individual state. This is of great concern to operators who plan to enter the industry. Operators will build budgets based on projections of online gaming being available to all 50 states. Those projections are at the mercy of each individual governor.

As online gaming is a strongly partisan issue, with conservative Republicans opposing the industry, it is reasonable to suspect several states may decide to opt-out. States that are considered most likely to opt-out are those that have two conditions. First, the state would not qualify to host online gaming, therefore, would not necessarily recognize any immediate economic benefit from online gaming. Secondly, states that have conservative governors are most likely to opt-out. While the governor has complete authority to opt-out, both these conditions must be present for opting out to be a viable option, politically. For example, while Haley Barbour of Mississippi is one of the most conservative governors in the country, it would be politically difficult for Barbour to opt-out if Mississippi is a qualified state to host online gaming, as this qualification would create immediate jobs and revenue for the state.

Several states meet both the above conditions, which presents concern for potential operators. The largest and most significant possible opt-out state is Texas. Rick Perry, the state's extremely conservative governor, is likely to be elected to his third term in 2010. As Texas is not a state that would be qualified to host online gaming, it fits the mold of a state that may opt-out. Most other states that fit the mold as being an opt-out risk do not present the level of problems that Texas does. States like South Dakota or South Carolina have much smaller economies than Texas, therefore, gaming operators recognize if those states opt-out it will not have the negative revenue effects that will occur if Texas opts-out.

Ensuring no online play is occurring within the borders of a state that opted out would be the responsibility of each individual online operator. The enforcement would fall to the state in which each operator is licensed. For example, if Texas opted out, an operator licensed in Nevada would have to ensure no wagers on their website were received from within the state of Texas. If Nevada regulators determined the operator was not in compliance, the operator would face disciplinary action, which could include losing their license to operate.

Given this opt-out problem, several casino operators who plan to enter the online gaming industry have lobbied for the opt-out provision to be removed. They quickly determined, however, that without the opt-out provision the legislation would not have enough votes to pass. In their lobbying efforts, they found the opt-out provision allows Republican legislators who oppose gambling to vote in favor of the legislation, passing the responsibility to oppose the legislation to individual states.

Political Positioning

Additionally, the regulatory structure proposed limits federal involvement in the industry. The Treasury Department would not have to expand. Republican legislators favor limited

Federal Government involvement in private industry and limited federal spending. By delegating regulatory responsibilities to individual states, legislators can continue with their talking points of supporting a small federal government.

United States vs. Worldwide

Another potential concern for gaming operators is that the Frank Bill limits online play to residents in the United States. As was discussed in Part Two, online gaming is truly a worldwide industry. U.S. gaming companies are lobbying for the scope of legislation to be expanded in this regard. It would be problematic, however, to allow U.S. operators to offer play to foreign countries where gambling is illegal. This could create an issue similar to the U.S. versus Antigua WTO dispute. U.S. operators understand this concern. Their position is that U.S. operators should be allowed to offer online gaming to foreign countries where online gaming is legal. Given the strict regulations the industry will face, enforcement should not be a problem. Furthermore, offering online gaming to foreign countries will expand the market, creating additional economic prosperity for both the private and public sectors in the U.S. Potential operators of online gaming must be cognizant of this issue, though, and recognize the real possibility that their product offering may be limited to residents of the U.S.

Responsible Gambling

As was mentioned in Part Two, conservatives often point to social concerns for their opposition to online gaming. These mostly include underage gambling and problem gambling. The Frank Bill addresses these concerns. The Bill requires the Treasury Secretary or any state or tribal regulatory agency to create regulations for the development of a problem gambling, responsible gambling, and self-exclusion program. To combat problems of irresponsible gambling, the Frank Bill requires online gaming operators allow players to “self-exclude.” This

means people can put their names on a list and that person will be denied all gambling privileges from online gaming operators.

The bill does not go far enough to address problem gambling, however. A self-exclusion list forces players to make all-or-nothing decisions. A player should have more options. Players should have the ability to limit themselves based on stakes of games, loss limits, deposit limits, and/or time limits. These limits support responsible gambling. These limits allow players to restrict the amount of money they can wager or the amount of time they spend engaged in online gaming, without completely excluding themselves from the activity. These limits are akin to walking into a bar and telling the bartender the amount of time you can stay, the amount of money you can spend, and the number of drinks you can have. These restrictions, assuming the bartender enforced them, would be quite productive in promoting responsible drinking, and should be just as effective in promoting responsible gambling.

In addition to placing responsible gaming requirements on licensees, the Frank Bill places the onus for determining the age of each customer on the individual online gaming operator. In addition, the operator is responsible for ensuring no bets are taken from any state or tribe that chooses to opt-out. This will require operators to employ extensive technology to ensure compliance. It would be a disaster for an operator to spend millions on internet infrastructure and marketing of their website only to lose their license because they did not spend enough capital to ensure compliance with the requirements of the legislation.

Tax Structure

Finally, it is important for potential online gaming operators to understand the tax structure that has been discussed for the industry. Congressman McDermott of Washington introduced the Internet Gambling Regulation and Tax Enforcement Act of 2010 (McDermott

Bill), a companion bill to the Frank Bill, which seeks to amend the internal revenue code to impose an online gaming license fee on internet gaming operators. The McDermott Bill does not propose a complete tax structure for the industry.

Other bills that have been drafted but not introduced on Capitol Hill do include a tax structure. This will certainly be a point of debate as the legislation moves forward toward a vote. Several structures have been discussed, however, all agree that the tax must be three-pronged. A portion will go to the federal government, a portion will go to the state where the online gaming company is located and licensed, and the final portion will go to the state where the player is located. The percentage taxes discussed and proposed below should be based on gross revenue received by the online operator. Gross revenue is defined as all deposits into player accounts less all withdrawals from player accounts. So, if in a given time period, players deposit \$1,000 and withdraw \$900, the operator will be taxed on gross revenue of \$100.

Assuming the regulatory model described in this section is implemented, the federal government will have very little responsibility for oversight and regulation of the industry, however, the federal government will still receive a portion of the tax collected. This is another reason Republican leadership should favor the bill. As described earlier, the proposed regulatory structure would not increase the size of the federal government, yet the federal government would receive a part of the tax. This equates to free money. This portion of the tax should be set at 2%. The McDermott bill calls for a 2% online gaming license fee; however, given the proposed regulatory structure the federal government would not be participating in the licensing. The federal government will receive the same percentage, without any of the work.

The second prong of the tax will be received by the qualified state where the online gaming operator is located. This state will receive tax revenue because the state will be

responsible for the licensing, regulation, and enforcement of the industry in that state. This tax should cover these costs. For example, if an online gaming operator is located in Nevada; Nevada will receive this tax. However, if a different online gaming operator chooses to be located in New Jersey; New Jersey will receive this tax. Most potential operators agree this tax should be 3%.

The third prong of the tax will be received by the state where the actual player participates in online gaming. If a player is located in Maryland, playing on a website located in Nevada, this third prong of the tax will be received by Maryland (the second prong of the tax will be received by Nevada). Again, it is generally agreed that this tax will be 3%. This aspect of the tax is important in making the legislation politically palatable. As was discussed earlier, it is a concern of operators that some individual states may opt-out. Opting-out would deprive the state of any revenue from online gaming. Texas was discussed earlier, so let's use that example again. We can conservatively assume online gaming play in Texas is 1/50th of that in the entire country. Using 2009 revenue totals (\$5.1 billion for the U.S.) each state generated approximately \$102 million (Holliday et al., 2010). Obviously, a state of Texas's size generated more revenue than the average state; therefore, this is a conservative estimate. At 3%, Texas would receive \$3.06 million in tax revenue for doing absolutely nothing. The state would not have to regulate or enforce the industry in any way. Therefore, if the state opted-out, it would be turning down over \$3 million dollars. Given that most states are struggling to balance their budgets, it is politically difficult for a governor to turn down "free" money based on ideological opposition to gambling.

Competition

It is vital for potential online gaming operators to understand all aspects of the Frank Bill, as well as any future political legislation that can affect this industry. In addition, it is wise for casino operators to consider their competitors before diving into online gaming. It is easy to predict competitors based on current gaming operators. For instance, MGM Resorts would figure its competition is primarily Harrah's, Wynn Resorts, Las Vegas Sands, etc. Operators must also consider the threat of non-gaming companies. Database management is important in growing a land-based casino business. It will also be vital in securing loyal online customers. Given the importance of a database, and the obvious importance of technical expertise in designing consumer-friendly websites, competition may go beyond traditional casino operators.

Facebook is a company that will play an important role in this industry. Facebook has immediate access to over 500 million users. That is the equivalent of a 500 million person database. Further, the company does not have to spend marketing dollars to grow that database; it does so naturally as people flock to Facebook. Further, the company can control the advertising its users receive through its website. Even if Facebook does not choose to enter the online gaming market, the company will be a valuable third-party partner for a company that does compete for online gaming customers. Again, access to Facebook's users and access to advertising to that large a database is extremely valuable. Operators must consider how to best compete with, or partner with, non-gaming companies to maximize online gaming's potential.

Conclusion

This section presented a preferred regulatory scheme for online gaming. This regulatory scheme is based on the Frank Bill, but incorporating several changes that will prove politically palatable for members of both parties. As Part Two detailed, the current political climate is

extremely partisan. This must be considered when structuring legislation. The regulatory scheme presented allows each party to benefit from online gaming while staying true to their party goals and values.

Additionally, several issues for online operators to consider were presented including the participation of Indian tribes, the opt-out provision for individual states, the responsible gaming requirements, and a possible tax structure for the industry. Finally, the power of non-gaming companies as potential competitors and/or partners was discussed. Operators must continue to monitor and consider these issues when making strategic decisions.

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