

Statement of Sanford I. Millar, J.D., MBT
Before the Senate Committee
On
Governmental Organization
February 9, 2010

Mr. Chairman and members of the committee, I want to thank you for the invitation to appear before you today and testify. The subject of Internet gambling and in particular Internet poker is both straight forward and also very complex. Fortunately, California, if it is willing, can draw upon the experience of other jurisdictions to craft a regulatory system that can maximize revenues for the state and encourage its people to participate legally in on-line poker. If California does not learn from others, its people will continue to visit unlicensed providers of poker and other games and lose an important source of fresh revenues for this state. It is my hope that the Legislature and the Governor can come together to adopt a licensing regulatory regime that is open to all gaming providers and is consistent with the current Tribal–State Compacts?

Over the last 15 years I have worked with many of the companies and individuals that you will also hear from today. I am a lifelong resident of California. I have practiced law in California for 35 years. I am a tax and gaming law attorney. I have worked as in house general counsel to Centaurus Games, LLC and other companies and I have served as outside counsel for variety of internet entertainment companies. I am very familiar with internet gaming. I am a member of the International Masters of Gaming Law. I appear today as a

consultant to the CTBA and as contributor to the report prepared by Michael Genest for the CTBA¹.

In the course of the last 15 years I have witnessed the growth of Internet poker from a cottage industry to a maturing market sector with small, medium and large companies and in a few cases state run enterprises aggressively competing for market share. It has been estimated that there are globally in excess of 550 online poker companies operating over 2,300 sites which run on 45 platforms. Some of the competitors in Internet poker are now very well known, even household names in the gaming sector. The sector participants range from traditional brick and mortar companies, who have internet divisions, to companies that have Internet only operations, to technology providers and software development companies.

There is no doubt that many people use the internet for a portion of their leisure time experiences and some choose to play poker on line, whether for fun or to gamble or as on-line poker professionals. There are some important issues with respect to the role of both the federal and state governments and many of these issues are quite complex.

The issues that I am going to testify about today are the following:

- (1) Should California legalize internet poker?
 - a. The choices are:
 - i. Adopt enabling legislation under the intrastate exemption of the Unlawful Internet Gambling Enforcement Act of 1986, (“UIGEA”).
 - ii. Wait for federal enabling legislation, like that being considered in the House and Senate and then either “Opt-in” or “Opt-out”.

¹ Letter dated January 29, 2010 from Genest Consulting to California Tribal Business Alliance

- (2) If the state chooses to legalize internet poker which regulatory model should it choose? The alternatives are;
- a. Monopoly model
 - b. Licensing model
- (3) Assuming California acts under the intrastate exemption of UIGEA, are the revenue and market forecasts you have seen reliable and if not why not?
- a. What is the effect on forecasts of competition from offshore operators who have “extraterritorial” licenses?
 - b. Can the state effectively limit competition from off-shore (sp) operators by restricting access to sites or restricting advertising?
 - c. What other competitive forces come into play?
- (4) Would the licensing of intrastate poker violate the “exclusivity clauses” of the current Tribal-State Compacts?²

Overview

In essence the discussion today and for the foreseeable future will hinge on: first, whether there is a viable revenue model to move California toward regulation on an intrastate basis and if so, what is that model (monopoly or license), and; second, what is the effect of the Tribal-State Compact “exclusivity clauses” on this industry?

Summary Conclusion

The integrity of any revenue model is dependent on the discount attributable to the effects of off-shore competition. Under a monopoly model the discount will be greater than with a licensing model. However, neither model will overcome the loss of revenue to the state if the licensing is found to violate the “exclusivity clauses” of the Tribal State Compacts.

DISCUSSION

² Article II. Section 3.2 of the 2004 Amendments to One of Five Tribal-State Compacts

Monopoly or License Models

First, a bit of background on internet gaming. Poker is but one aspect of the internet gaming sector. Some of the written discussion has broadly referred to all Internet gambling in describing the market. We need to focus only on poker. Internet poker players break out into three discrete groups. There are individuals who play for fun only, those who play on subscription sites or virtual prize sites for fun and prizes and those who play in these “real money” games. It is the real money group that is the focus of regulatory efforts and is the biggest source of potential licensing and income tax revenue.

As a point of reference, according to the web site www.PokerScout.com, (a credible industry source) there are currently 13 sites that they follow that accept U.S. players for real money poker and all of these would appear to accept players from California.

There are approximately 76 jurisdictions that license Internet Gambling³ (all forms, including: sports, horseracing, skill games, including poker, bingo and lotteries). There are, various regulatory models being used at the nation state level. A good example of differing approaches is seen in Europe where at least two approaches are used. One is the licensing model and one is the monopoly model. All other models derive from these two. Both of these models have their limitations and benefits. In the United States we have a potential third, nation-state model. The nation-state model as seen in the Frank⁴ and Menendez⁵ bills would be a hybrid of the licensing model at the federal level but then the states which choose to “opt out” can decide which model to use if they elect to regulate under the intrastate exemption.

³ Jason Gross, Internet Gambling & the Law-Prohibition vs. Regulation, 14 Metro.Corporate Counsel, Aug. 8, 2006, at No. 8

⁴ H.R. 2267-H.R. 2269

⁵ S 1597

There is also a derivative of the licensing models and that is extraterritorial license which is the form of license used by offshore operators⁶. Under this form of regulation, companies obtain licenses to operate from the licensing jurisdiction, but not within the jurisdiction. The servers and other facilities are based in the jurisdiction but the customers are not. The compliance controls, both gaming, and financial are done in accordance with the regulations established by the hosting jurisdictions licensing authority. These are typically low tax or low free jurisdictions and generally allow the site operator great flexibility. Some of these jurisdictions have developed sophisticated systems and are very diligent in supervision. But it is the extraterritorial model, itself, that is the foundation for the offshore operators.

The UIGEA is one of the responses of the United States to the extraterritorial model and to offshore operators. UIGEA provides for the ban on unlawful internet gambling by seeking to control the flow of funds, specifically through credit cards transfers. Its focus is the regulation of payment processors. MasterCard International, Visa International and other credit card companies have stopped processing credit card payments originating from the U.S. which use the merchant code attributable to gambling, code 7995. It is important to note that the UIGEA regulations exempt from the processing ban, ACH systems,(debit cards), check collection systems and wire systems⁷. It is through these devices, ACH (debit cards), checks and wires, as well as eWallet companies that the offshore companies (identified on PokerScout.com) are able to get money from players in the U.S., including California and to pay out winnings.

It is only recently that the federal government has taken enforcement action against some payment processors by seizing funds on deposit and the associated

⁶ Among the licensing jurisdictions are: Antigua-Barbuda, Alderney, Costa Rica, Dominican Republic, Gibraltar, Ireland, Isle of Man, Kahnawake, Malta, Netherlands Antilles, and Panama. A list licensing jurisdictions compiled by GamblingLicenses.com is available at its website.

⁷ 12 C.F.R. 233 and 31 C.F.R. 132

records and initiated prosecutions⁸. However, in spite of the seizures and prosecution, the offshore operators continue to operate and even grow. They pose a serious competitive threat to a wholly intrastate market such as that which California would offer.

A good point of reference to see the effect of offshore competition on a state monopoly is to look at the Swedish model. Sweden has a state licensed monopoly system and yet it has, according to Deutsche Bank only a 30% market share⁹. The remaining 70% of market share leaks to sites unlicensed in Sweden. The explanation is not as a result of weakness in the Swedish regulatory scheme, it is an example of how the extraterritorial model works. The licensing jurisdiction allows an operator to host its operations in the licensors facilities and reach outside its borders for customers. Sweden is also a bit late in getting to the market having entered when offshore sites have built brand identity and loyalty. Similar to what could happen in California. There are forecasts that anticipate growth in Sweden of the market share for its monopoly, but the competitive forces will still be there¹⁰. It should also be noted that Lotto-Quebec announced February 6, 2010 that as the monopoly online operator in Quebec Province it will offer online poker in the second half of 2010¹¹, but Italy has just moved from a monopoly model to a licensing model.

It is worth noting that there is no homogenous license fee (tax rate) through the various licensing jurisdictions¹².

An example of a current tax rate in a licensing jurisdiction is the Italian approach. The Italian regulatory regime has a differentiated license rate. The license rate ranges from 20% of GGY (revenue) for cash games and for casino games, to 11%

⁸Example: United States vs. Douglas Rennick, USDC (SDNY) 09Crim752; In the Matter of the Seizure of the Contents of One Citibank bank account. USDC (Maryland), Case No. 09-2891

⁹ Deutsche Bank Company Alert: Party Gaming PLC 11 Jan 2009

¹⁰ Lotto-Quebec announced February 6, 2010 that as the monopoly online operator in Quebec Province it will offer online poker in the second half of 2010.

¹¹ Pokernewsdaily.com, February 7, 2010

¹² A complete comparative analysis of tax and license rates is beyond the scope of this statement

for bingo, down to 3% for poker¹³. Other examples of licensing jurisdictions are Gibraltar which has an annual license fee of 2,000 (GPB) plus 1% of GGY with a cap. The U.K. has a licensing fee which is 15% of gross profits.

What is important to note is that the economic risk in the two models is very different. In state monopoly jurisdictions the operator typically pays a fee to the software and technology operator, and the state owned operator bears most of the market risk, including the risk from offshore competition. The risk of success is shifted to or borne by the state. In the licensing model, the licensee has the entrepreneurial risk. The Swedish experience is an example of what happens when a monopoly market is faced with offshore competition. The Italians are also illustrative for having moved from a monopoly to a licensing model. But these again, are nation state jurisdictions.

The unknown factor here is consumer behavior. How will consumers respond when faced with a choice of a regulated activity wholly in state, which requires proper identification, tax compliance, age and location monitoring when there will still be access to the off-shore operators.

There are several methods of attempted Internet regulation none of which truly successfully impair the extraterritorial reach of otherwise unlicensed companies. The methods breakdown into (1) nation-state censorship¹⁴, (2) advertising bans by imposing sanctions on ISP's¹⁵ and (3) censorship of other forms of media advertising. None of these approaches in and of themselves work on a nation state imposed basis let alone have any been proven to work in a single state like California.

Here are just some of the methods used to avoid censorship by the extraterritorial operators and attract new customers. First, some operators have "free play" sites that sponsor television programs. These sites use a domain URL

¹³ GamingTechLaw.com January 28, 2010

¹⁴ China as an example

¹⁵ Italy implemented ISP blocking which the AAMS determined was of limited effectiveness

that usually ends in .NET or .TV. The consumer is counted on to recognize that the most common domain is .COM. The consumer may instinctively direct himself or herself to the .COM site. In addition the sites use online magazines and information sites to host advertising for their .COM site. They also use “blogs”. The site operators also use traditional print. The operators use these in combination with customer sign up and retention bonuses and celebrity player endorsements. All of which serve to build their brands and their market share. It is worth noting, that on the most prominent offshore sites, a full 75%-80% of all players are playing for free. The play for free offer and learn to play is a key recruiting tool for the real money games. Further, and most importantly, the extraterritorial operators are not limited by geography. They create player liquidity pools on a global basis, as opposed to having to deal with a physically restricted geography and inelastic pool of players. The global reach allows for constant regeneration of players.

The question then is can the state licensed site operating in fixed geographic boundaries, compete for market share with already established and well branded offshore operators. Put differently, is censorship an answer? No.

Internet censorship is a highly controversial issue and one that should be considered with all due caution and in light of the already existing ability to avoid restrictions on marketing by nation state regulators, it is doubtful that California could implement a system of internet advertising censorship that would pass legal challenge and work. This committee should recognize that any proposal that bases its license fee forecast to the state on a premise of Internet censorship is deeply flawed. Further, ISP regulation while tried in Italy¹⁶ has not proved to be truly effective when done at the nation-state level. It is doubtful whether the state could impose ISP blocking mechanism that did not meet with federal challenges.

¹⁶ Italy has moved to adopt a licensing model

In essence, the intrastate model may very well “ring fence” California by preventing it from reaching players outside the borders of the state, but yet be a target for offshore operators who choose to continue or choose to enter this market. They can add to their player liquidity pool by drawing from California, but California could not reach outside its borders to compete.

As I stated earlier, I consulted with Michael Genest on the letter delivered to the CTBA which you should all have. I did so with the understanding that I would testify here today with the express purpose of helping you find a path through the conflicting opinions, and proposals. The market and revenue data is difficult to assess, because most of the analysis is based upon projections of will happen using assumptions that may not accurately assess the effects of offshore site competition. The just mentioned issues should be sufficient to cause concern about any revenue forecast that does not consider the effect of offshore competition.

Exclusivity

But there are other issues to consider as well. In seeking to reach the leaching revenue (that is the lost tax and potential licensing fees or revenue share) whether through a monopoly model or a licensing model California runs head long into a battle with holders of Tribal-State Compacts. The battle will be over the enforceability of the “exclusivity” clause in these Compacts.

In the Genest letter we discussed the financial repercussions of violating the “exclusivity” clause. The Compact revenue runs at about \$1m per day or \$365m per year. The State runs the risk of losing that revenue if it violates the provision on “exclusivity”. The revenue estimates from licensing Internet poker, which are set forth in the Genest report, show that the licensing fees would be a fraction the Compact revenue. Even if you were to accept other estimates the cost benefit does not seem to lean in favor of the violating the Compact.

What some of the forecasts fail to consider is the fact that the Compact revenue has an estimated life of 20 years which must be balanced against the uncertain forecast of a consumer on an internet poker site with a geographically defined player pool. It has already been stated by some Compact members, including those who are members of the CTBA, that the licensing of internet poker would violate the “exclusivity” clause of the 2004 and 2006 Amendments to the Compacts. I have not seen a 20 year Net Present Value forecast by any proponent that forecasts internet poker revenue from a wholly intrastate operation in California. This is an important omission from the data as the NPV of the two income streams needs to be compared, not just short time periods in order to determine the real cost benefit figures.

I recognize that the Legislative Counsel on April 11, 2008¹⁷ came to a different conclusion, based upon a review of the 2006 Amendment, but apparently without consideration of the 2004 Amendment or the opinion of the National Indian Gaming Commission of December 21, 2004¹⁸. Without belaboring the point, this is a huge issue. It should be clear, however, that there is no agreed position among the Compact participants on allowing Internet poker.

There are some who suggest that the State wait and see if the proposals being discussed in House and Senate produce a federal bill and then make a decision on whether to Opt-in, or Opt-Out. There are others who suggest that the state move forward on an intrastate basis. There may be some merit in deferral to gather more data and better enable the state to make an informed decision on whether to join a federal regime or not and which model, monopoly or licensing to choose, should the state so decide.

You have a very difficult task. The people you will hear from today are all very knowledgeable and of high character. They all speak from strong conviction. I am willing to work with you and them to help guide us to a workable result.

¹⁷ April 11, 2008, ONLINE POKER: State Authorization- # 0808054

¹⁸ Opinion of Whiting Hagg & Hagg, December 21, 2004 Re: Classification Opinion...

I thank you for your time.

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