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Licensing

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INTRODUCTION

This chapter recommends a model approach for government licensure of the Internet gaming industry. Unlike some other areas of regulation, no best licensing practices exist. Each government must consider what is the best licensing structure to employ in light of its unique circumstances, such as its public policy, regulatory funding and resources, industry resources, and market size. All of these factors can influence the regulatory structure in general and licensing in particular.

A model approach, as opposed to best practices, provides a framework for what the government should consider in crafting and implementing a licensing system that best reflects the government's goals and resources. The starting point for such an approach is an understanding of the government's interest in licensing parties involved in the industry. This requires the government to identify public policies and policy goals by determining its position toward Internet gambling, what goals it hopes to achieve related to such gambling, and how regulation in general and licensing in particular can help achieve these goals. This inquiry is covered in section 1. Section 2 covers the economics of licensing. Governments need to understand the costs of imposing licensing and the non-licensing alternatives for achieving policy goals. Once the government determines the goals of licensing and considers the attendant costs, it must put into place a structure that considers who the government needs to license, the level of scrutiny for such licensing, and the standards and criteria for evaluating license requests. The government/licensor must understand the range of parties interested in Internet gaming, the responsibilities of those parties, and how each could impact the government's policy goals before it can decide who needs to be licensed. Section 3 addresses these issues.

1. LICENSING AND PUBLIC POLICY

Licensing is a tool to achieve specific public policy goals by excluding persons from an industry, occupation or profession before their actions can compromise public policy. Licensing is not unique to Internet gaming. Governments often impose licensing requirements on various professions to protect the public. For example, lawyers, doctors, contractors and even beauticians have to go through some level of licensing scrutiny before they can offer their services.¹ Licensing is most valuable as a tool to shield the public from abuse where the person being licensed holds a special position of trust, the public is in a vulnerable position, regulatory violations are difficult to detect, and enforcement is of limited utility. For example, a gaming site operator could easily victimize the public by using rigged games. One scandal that plagued the online poker industry allegedly involved associates of a former poker site owner. Those associates accessed an internal system which allowed them to view other player's hands at the poker table.² This method of cheating gave the cheaters a significant advantage and resulted in players losing millions of dollars.³ Since these types of occurrences may be difficult to police through enforcement, licensing provides governments with a tool to achieve policy goals, such as maintaining the fairness of the games by preventing dishonest persons from operating licensed gaming sites.

Considering the risks and vulnerabilities associated with Internet gaming, licensing is a prophylactic exercise. Some cases may exist where the applicant has such a sordid history or poor reputation that his or her mere association with the industry is inconsistent with policy goals. But, this is rare and most often regulators attempt to use licensing to exclude unfit persons before they enter the gaming industry, as well as to inform those qualified persons of the standards expected of them. In this light, licensing is a means to predict the behavior of the license applicant with the objective that only those qualified entities and individuals, i.e. those who do not pose a threat to the public, withstand licensing scrutiny.

The foundation of gaming licensing is a determination of the government's public policy toward gambling generally and Internet gaming specifically. From this public policy, governments can craft policy goals that it hopes to accomplish through regulation. Suppose that the only policy goals are to assure that the games offered on regulated sites are fair and honest. The suitability review of applicants for an operator's license may not be limited to dishonesty; it may also require that applicants have sufficient competency to detect and prevent schemes by employees or third

¹ *In re Application of Cason*, 294 S.E.2d 520, 523 (Ga. 1982) (citing *Penobscot Bar v. Kimball*, 64 Me. 140, 146 (Me. 1875)).

² Mike Bruner, *Poker site cheating plot a high-stakes whodunit*, MSNBC.com, (Sept. 18, 2008), http://www.msnbc.msn.com/id/26563848/ns/us_news-crime_and_courts/t/poker-site-cheating-plot-high-stakes-whodunit/

³ *Id.*

parties designed to cheat players. In this context, licensing would seek to protect the public by requiring licensing of persons with responsibilities that if not performed competently and honestly could compromise the honesty or fairness of the games. This, as an example, could include site owners, software architects and programmers, data and server centers and other persons with access to sensitive areas of the Internet gaming systems. It could include reviews of the applicant's honesty, experience, competency, or technology infrastructure. If the goals are expanded to assuring that player funds are protected, the scope of the licensing review may include the financial strength of the operator. Suppose further that a government expands its policy goals to assure that the gaming markets are competitive to allow licensees to compete in world markets or to assure the lowest costs to players. In this case, the government needs to balance the cost and impact of licensing on competitive market conditions.

Absent an understanding of what the government wants to accomplish through regulation and licensing, regulators have no context for the various licensing requirements. This can result in widely inconsistent actions by regulators who substitute their own beliefs or assumptions, or those of their perceived constituency, as to the goals and methods of regulation. This can create conflicts in approach to licensing between agencies, regulators, and even staff.

Once a government formulates a public policy toward Internet gambling, it must set and implement policy goals based on that public policy. Implementation usually involves both adopting and enforcing laws designed to achieve policy goals. These laws can restrict, mediate or promote the activities of, or by, private parties.⁴ Regulation is a common method of implementation. This is the process by which government achieves policy goals by restricting the choices of private parties.⁵

In the context of gambling, public policy most often focuses on either player protection or government protection, or a hybrid of these policies.

Player Protection Policies and Goals

Public policy that focuses on player protection has among its primary goals to assure that the games are fair and honest and that player transactions (deposits, payments, and transfers) and account balances are secure.

Honesty refers to whether the site operator offers games whose chance elements are random. The concept of random is elusive and its precise meaning has long been debated among experts in the fields of probability, statistics and the philosophical sciences. A standard dictionary might define random in a general sense as "having no specific pattern or objective; haphazard," or "made, done, or happening without conscious decision." These same dictionaries also might provide a meaning in a more

⁴ BARRY M. MITNICK, *THE POLITICAL ECONOMY OF REGULATION* 8, 9 (1980).

⁵ *Id.* at 20.

specific statistical sense such as “a phenomenon that does not produce the same outcome or consequences every time it occurs under identical circumstances,” or “an event having a relative frequency of occurrence that approaches a stable limit as the number of observations of the event increases to infinity,” or even “governed by or involving equal chances for each item.” All of these definitions are lacking in some way for purposes of establishing necessary criteria for randomness in games of chance. Randomness in the context of gaming is the observed unpredictability and absence of pattern in a set of elements or events that have definite probabilities of occurrence. For example, a slot machine is honest if the outcome of each play is not predetermined or influenced beyond the established house advantage (or player’s skill) in the gaming operator’s or another player’s favor.

A second aspect of honesty is whether forces outside of the established rules of the game influence the outcome. Take, as an example, community poker. The method of shuffling/distributing cards has to meet prescribed standards of randomness. But, beyond this, the game must be free of collusion between players and have controls to prevent players from gaining an advantage by having access to hole cards or unexposed cards in the deck. Like much of Internet gambling, detection of collusion is not a problem that can be solved exclusively by technology. HUDS (heads up displays) can provide operators with monitoring, but interpretation of that information, like casino surveillance, is an art requiring training, competency and integrity.

Fairness deals with whether the operators are offering games that give the players a reasonable opportunity of winning. This is a form of price setting because game odds determine the cost that players have to pay to play house banked casino games and rake requirements determine the cost of playing community pooled poker. In a perfect economy, market forces would determine pricing because the players would have access to all the information necessary to determine the costs of playing and could chose the best price among multiple competitors. In house banked casino games, the cost of playing is reflected in the house advantage. In community games, it is the house commission such as the amount of the rake in poker. Most gaming markets are not perfect and regulators may attempt to ensure fairness by either requiring disclosure of game odds or setting the maximum price a casino can charge players for the gambling experience. Ensuring a competitive market through full disclosure of odds information and price setting on house commissions can accomplish policy goals related to fairness, though the competitive market is more efficient at setting a fair price than regulators.

Fairness in the online poker industry may also extend to other prohibitions. As an example, governments may prevent the use of certain software programs (often called “bots”) used by some participants in non-house banked games. Bots use probability driven algorithms to

create a statistical advantage over most human players. Other examples of fairness concerns related to online poker may include allowing player collusion or allowing a player to have more than one seat at a poker table.

Player protection goals also extend to industry regulations that minimize undesirable social consequences. These social consequences can apply to the general population or focus on a specific sub-population that is considered worthy of special protection. One broader concept is the notion that gaming operators should not exploit the public by encouraging them to gamble, should not exploit players by encouraging them to gamble beyond their means, and should not convince players to wager more than they otherwise would without encouragement. Governments may adopt laws that prevent gaming operators from advertising, offering incentives to gamble or conducting other activities that stimulate demand for more gambling.

While broad prohibitions on advertising or incentives are rare in the Internet gaming industry, other measures directed at the general population are more common. These efforts to minimize undesirable social consequences could include a general prohibition against the use of credit, operator or player set daily loss limits, maximum or player set playing times, display of time at play, or requirements that sites or advertisements contain language regarding the dangers of problem gambling or access to problem gambling help lines.

Some player protection goals, such as excluding underage players, may relate to specific subgroups. One group that is often given special consideration is problem players. A solution for problem players could be mandatory exclusion of problem players who are voluntarily or otherwise entered onto a list.

Player protection also can focus on protecting the player from other potential harms, most notably protection from risks to player data and privacy that are derived from playing on the gaming site.

Finally, player protection also can focus assuring that the site operators timely pay winnings and protect and return player funds on deposit with the site.

From a licensing perspective, unsuitable persons under the player protection goals could include those who would (a) cheat the players, (b) fail to take measures to prevent others, including employees or players, from cheating or taking advantage of others through the use of bots, by collusion or otherwise, (c) provide or permit games that are unfair, (d) fail to timely pay winnings or protect player funds, (e) evade regulations that discourage the stimulation of gaming demand or fail to implement such measures, or (f) violate or fail to take measures to protect the public generally or vulnerable classes of persons, specifically including problem gamblers.

Government Protection Goals

Governments may have a more selfish reason to prevent the involvement of persons who could, indirectly or directly, jeopardize the government's economic stake in the Internet gaming industry. While the player protection goals support regulation for the player, a government protection framework sets goals and provides regulation to protect the interests of the government. By way of analogy, banks tend to place restrictions on businesses they lend to: if the bank lends a few hundred dollars to a borrower, a simple promissory note might be a few pages long; however, if a bank lends a hundred million dollars, the loan documents may be hundreds of pages long. In both cases, the bank wants to see the businesses succeed, but it puts more restrictions on the second borrower because the bank's interest is greater.

Government protection goals often predominate where the government places a heavy reliance on the industry to meet tax expectations. Persons who can do direct harm to government interests include those who skim funds without paying taxes or are so incompetent that the government will lose tax revenues through employee or player theft or poor management. Governments may also have an economic interest in the regulated industry's impact on job creation and economic development. Government protection goals would also shield the industry from threats to its existence, thereby protecting the government's revenue stream and any other economic benefits created by the industry. The gaming industry faces eradication if the public, or public officials, perceives it as too problematic for any number of reasons, including that it is too intrusive, not subject to proper regulation, or is infiltrated by persons who are dishonest, associated with organized crime, have dubious reputations or otherwise taint the industry. For example, in the United States, if a state government permits Internet gaming, its regulations must assure that persons physically located in other states which prohibit Internet gaming cannot access and play on the licensed sites. Failure to do so could result in a federal prohibition of all Internet gaming to protect the interests of the states that prohibit online gambling or because of the negative publicity associated with criminal proceedings against licensed online operators that failed to respect jurisdictional prohibitions. In addition to the federal threat, state voters or legislators can change the laws permitting Internet gaming. Gaming is different from most other industries because it is often perceived as a vice. Its very existence may be tenuous, as public perception of the benefits and burdens may change and influence the legality of the activity.

Besides the threat of legislative intervention, players collectively have the economic ability to impact the government's tax and economic interests by not playing on licensed sites. For example, assuring the honesty of the games is important because the public must perceive that gambling is honest before it will play. If one operator cheats, the public may believe

or fear that the entire industry is dishonest. Additionally, the gaming industry can suffer credibility problems if the media exposes a site owner or operator as having criminal ties, regardless of whether the owner or operator otherwise complies with all regulations and acts ethically.

A third policy for governmental involvement is to assure that the gaming industry does not interfere with other government goals. For example, the government's best interests dictate that the online gaming industry not become a conduit for money laundering. Malta specifically looks to whether the applicant has followed practices to prevent money laundering and other suspicious activities before issuing Internet gaming licenses.⁶

Finally, government protection also is promoted if the jurisdiction does not suffer reputational damage and resulting loss of business if a site operator fails to timely pay winnings and protect and return player funds on deposit with the site.

From a licensing perspective, unsuitable persons under a government protection framework could include those who would (a) cheat the players, (b) fail to take measures to prevent others including employees or players from cheating, (c) provide or permit games that are unfair, (d) fail to pay winnings or protect player funds, (e) evade the payment of taxes, (f) associate with persons whose reputations can harm the industry, or (g) violate, or fail to take measures to prevent violations, of laws designed to protect the industry or the government's other interests.

Hybrid Systems

Most frequently, governments do not strictly follow either the government protection or player protection goals, but instead blend aspects of both goal sets. For example, a jurisdiction could view the financial reward from gambling to be generally greater than the potential harm. These hybrid systems may try to reap the revenues from gambling, but minimize the harms, particularly to its citizens, by using regulation to limit those aspects of the industry that do the most harm. If done properly, the government can assess the cost of the regulation (as reflected by the cost of implementation and loss of revenues) and compare that value to the cost of not regulating the matter at issue (costs to the government, the public or the players).

Because government and the player protection goals often overlap and most jurisdictions are hybrid systems, the basic structures of many gaming license regimes are often quite similar. However, sophisticated jurisdictions demonstrate nuanced differences in all aspects of regulation including licensing.

⁶ Malta Remote Gaming Regulations, § 8(2)(g) (2004) (amended 2011), *available at* <http://www.lga.org.mt/lga/content.aspx?id=87374>

2. LICENSING AND ECONOMICS

Licensing would be fairly simple if jurisdictions could design licensing systems without concern for the cost to the government, those regulated and the market being regulated. This is not realistic because an overly burdensome licensing scheme can, in different ways, impact the government's goals, the financial viability of regulated industry and those who the regulations are intended to protect. Much of this is attributable to how regulation, including licensing, can impact market economics.

The theory of market economics specifies a number of basic conditions needed for a market to set prices efficiently. The greater the deviation from these conditions, the less efficient the market system becomes. A basic condition of efficient pricing is that markets must be competitive. Of all factors necessary to support a free market model, a key is the absence of barriers to entry.⁷ Barriers to entry are factors that discourage entry into an industry by potential competitors and, thus, allow established firms to earn super-normal profits. Government restraints, including licensing requirements, are barriers to entry that can prevent the casino industry from forming a competitive market.

The online gambling industry does not have many natural barriers to entry. For example, online gaming is not necessarily a capital intensive venture. Likewise, gambling is fairly fungible, with the exception of the few proprietary games. Similar dismissals of the other types of barriers to entry can be made with one major exception - government intervention including licensing.

Licensing, as a government restraint, will have economic costs. As an example, if licensing costs or requirements are too high, licensed gaming companies or vendors will gain protection from competition. The resulting monopoly and oligopoly markets create higher cost to the consumer, less innovation, lower service levels, and lower output. In the gaming industry, lower output means higher net profits on lower gross revenues. If a government bases tax rates on gross revenues, it will suffer a lower overall tax return.

⁷ These barriers can take on a number of different forms. Barriers to entry include:

- A. Extreme or significant capital requirements resulting from scale effects.
- B. The existence of patents or copyrights.
- C. Scarcity of or control over a necessary resource.
- D. Excessive skill or knowledge requirements.
- E. Social, cultural, or religious taboos.
- F. Absolute cost advantages, *i.e.* advantages possessed by established firms who are able to sustain a lower average total cost than new entrants irrespective of size of output.
- G. Large initial capital requirements.
- H. Product differentiation, either natural or artificial, such as advertising.
- I. Retaliation or pre-emptive actions.
- J. Vertical integration, *i.e.* requiring entry at two or more levels.
- K. Governmental restraints.

Governments must strike the proper licensing balance, consistent with their policy goals. Entry barriers can hinder other government goals. Silicon Valley in Northern California, a world center for high tech companies, would not likely exist if start-up companies with great ideas and little capital had licensing barriers. If a government has a goal to attract new technology companies and resulting employment through the legalization of Internet gambling, licensing barriers can prevent start up or thinly capitalized companies from entering the market.

Notwithstanding the above, licensing often has an important role to play in the gaming context. Indeed, the proper balance between licensing and barriers to entry is crucial. If licensing is too lenient, the industry may suffer if a scandal develops that harms the industry's reputation or results in legislation to prohibiting legal gambling.

Likewise, player protection goals may seek to insure that the players get the fairest price when they play with a licensed online site. If licensing results in oligopoly or monopoly pricing, this results in games that are less fair to the players. Consistent with government protection goals, the proper balance between licensing and barriers to entry is crucial.

A market can become a monopoly, oligopoly or competitive market through explicit licensing restraints, *e.g.* state law may dictate there only be a very limited number of site operators or system providers. As an example, the Nevada regulations only allow existing Nevada casino licensees to become licensed Internet gambling operators. There are certain other requirements, depending on the location of the establishment within the state, that existing licensees to have either a resort-hotel, a certain number of rooms or seats or have held a license for at least five years. Likewise, California has proposed legislation that would restrict licenses for site operators to certain tribes, card rooms and race tracks as well as limit the number of licensed systems providers that could service these site operators. If the federal government passes legislation, it will likely restrict operators' licenses to casinos, Indian tribes, racetracks and card rooms. Each of these decisions could impact competitive markets by allowing those fortunate enough to qualify for a license to reap greater than competitive returns. Any categorical restriction on who may obtain a license will create some level of entry barrier.

Barriers need not be explicit. They can result from cost, risk, time, opportunity costs or reputation. Even when the law does not dictate the number of site operators, it may influence whether a given market becomes a monopoly, oligopoly or competitive market. A government requiring a substantial investment to qualify for a license is an example. California legislation creates a vignette by requiring non-refundable deposits against the operator's tax liabilities in the amount of \$30 million. Any minimum investment requirement will create some level of entry barrier. Even if California allowed an unlimited number of licenses, the \$30 million deposit would constitute a significant barrier to entry. Such legislation may make

investment attractive for the first entrant who can make monopoly profits and, perhaps, even a few other entrants. At some point, however, potential competitors will not be willing to enter the market because the potential profits do not justify the capital costs.

Besides cost, the licensing system employed by a state will influence the number of competitors. In a perfect, competitive system, competitors will enter the market if the existing entrants are making extraordinary profits. How quickly or easily they can enter the market is greatly influenced by licensing. Existing competitors will have an advantage if the licensing process creates a significant barrier. Licensing can create barriers to entry in five major ways.

First, it can add uncertainty and risk to the decision on whether to enter a market, especially when regulators regularly deny licenses to applicants. All things being equal, a company will devote its resources to a market where it can more likely obtain a license.

Second, the length of time that a licensing investigation takes may create a barrier. Companies that want to enter a market do so based on the current market economics. If licensing takes a substantial amount of time, the company must forecast the economics for when it might obtain its license. This adds risk to the decision to enter the market. Moreover, the time and effort required in the licensing process are an opportunity cost; as such, effort could instead be directed to creating markets or expanding existing markets. For example, in Malta, the Lotteries and Gaming Authority (LGA), which regulates gaming in Malta, takes about two to three months to investigate an applicant and issue a license. This expeditious handling of license applications allows the prospective licensees to plan deployment and marketing strategies. Such planning is very difficult when licensing might take a year or more.

The third barrier is the cost of licensing. A potential entrant will consider the cost of licensing when deciding if its money will generate a higher return in this market as opposed to another.

Fourth is the burden that the licensing places on the applicant's resources. This includes the efforts of officers, directors, and staff needed to complete applications and successfully navigate the licensing process.

Finally, the licensing process may cause social stigma and embarrassment to a potential entrant. This may discourage some companies, especially diversified companies, where embarrassing disclosures in the licensing process could negatively impact its brand and other businesses.

These barriers can be particularly problematic as they relate to providers of goods or services. As an example, one emerging casino jurisdiction mirrored the regulations of a larger casino jurisdiction that required licensure for companies that manufactured chips and tokens. The cost of licensing under the regulations of the larger casino jurisdiction exceeded the value of any contract to supply chip to the emerging casino district. Had a company stepped forward and obtained a license, it could have effectively charged

rates so high that the casino would have forfeited a substantial portion of its table game profits just to purchase chips needed to offer the games. In the interactive gaming world, this can occur with service or software providers like site security or payment processors. The issue, posed as a question, is “will the largest and potentially the best providers of a service or software invest in the effort, time and cost of licensing for Internet gaming when other markets exist for its product without such barriers?”

Where reasonably efficient, proactive standards and enforcement can achieve public goals, they are generally preferred to licensing for two reasons. First, enforcement can provide a more certain and measurable result. Licensing attempts to predict behavior where standards and enforcement control behavior. Protecting player funds is an example. The licensing process tries to predict whether a future licensee is likely to divert player funds for other purposes. Conversely, a proactive standard might require licensees to physically segregate player funds under the control of a trusted third party thereby allowing the regulator to control the funds. Additionally, reasonable standards and enforcement may not create the same level of barrier to entry as licensing.

This does not mean that barriers to entry are not justified in many instances. For example, requiring that applicants have minimum reserves to assure the protection of players’ deposits is a barrier to entry which may prevent less financially endowed companies from entering the market. However a reserves minimum is a barrier that may be justified in jurisdictions that have a strong player protection sentiment.

Governments need to understand the costs of imposing entry barriers to assess their cost versus the benefits that they hope to achieve through implementation of those barriers. Simply put, the most efficient regulation is one that accomplishes key policy goals with the least impact on a free market economy.

3. LICENSING FUNDAMENTALS

Differences between licensing systems are based on five major factors: breadth, depth, level of review, criteria, and standards of the licensing process.

Breadth means the extent to which a government requires persons or entities associated with the gaming industry to obtain a license. For example, does a company that provides payment processing solutions for Internet gaming sites have to obtain a license?

Depth of licensing means the extent to which a government requires persons within a licensable entity to undergo an individual investigation. This could require that certain officers, directors, shareholders and employees associated with an entity applying for a gaming license file individual disclosures and undergo a background investigation.

Level of review refers to the intensity of the investigative process. A low-level

review might include simple criminal background checks. A high-level review may entail the regulatory agency train special agents to conduct a complete and independent review of the applicant, including both background and finances.

Criteria are those matters that the government considers in granting licenses. These can include moral character, honesty, connections to criminal elements, financial ability and business experience.

Standards refer to how rigidly the regulators will apply the criteria. For example, under the same set of facts, an applicant may obtain a license in one jurisdiction, but not another because one jurisdiction requires a higher standard of conduct than the other. As such, the minimum attributes of qualified applicants varies based on the standards used.

Breadth of Licensing

The Internet gaming ecosphere has many participants. Besides the owner and operator of the Internet gaming site, others—such as suppliers, service and providers—may serve integral roles in the creation and operation of an Internet gaming site.

The first major subset includes those with an economic interest in the success of the site, such as owners or investors, those who receive a percentage of profits and some creditors.

A second major subset is comprised of game software suppliers. These could include: the manufacturers of game content or systems including sports betting and exchange systems, casino games, poker software, bingo software and system software. These suppliers provide software for game play that may be exhibited in browser software, mobile or other applications. These vendors may or may not provide the back end software otherwise known as the system software. An operator may own this software, or license the game play layer.

A third major subset contains contracted non-gaming service and software providers. This is divided into two categories: software providers and service providers. Non-gaming service providers include payment processors, fraud prevention, customer service, domain name acquisition and management, affiliate management, bonus and loyalty management, network and chat management, hosting services, age and location verification, site optimization, and others. Non-gaming software providers include those whose products integrate into back-end gaming platforms to perform such functions as account management, affiliate and agent software, customer service tools, customer relationship management (CRM) tools, fraud and security tools, registration platforms, integrated cashier, centralized reporting tools, bonus and loyalty tools, network management tools and site optimization tools.

A fourth subset is network specific services including data and server centers and site security.

A fifth subset includes affiliates, marketing partners and other marketing resources.

1. *Those Having a Direct Economic Interest in the Success of the Business*

A. Owners

Owners hold the rights to conduct the online business. Owners may either operate the gaming site or hire a service provider to run the gaming site on their behalf. While owners who are not operators do not have direct contact with the software or with customers, they may have considerable influence over the website and typically share in gaming profits. Land-based casino jurisdictions generally require that casino owners be licensed.

Requiring owners to be licensed certainly advances player protection policies and goals. The owner has direct influence over the honesty and fairness of the gaming operations as well as control over player funds. These are key considerations for best regulatory practices in licensing. The owner also has the financial responsibility and ability to implement all the necessary systems and procedures to assure that players are protected from third party cheating, privacy violations and data theft. Owners also have primary responsibility for implementing compliance systems and programs designed to address problem gambling and other regulatory requirements.

Owner licensing is also consistent with government protection goals and policies. A government must consider not only the potential influence that an owner has over an operation, but also public perception of unsuitable owners (assuming the public knows who owns the domain name or any part of the online business). Indeed, the owner is typically the most visible person to the public.

Therefore, under both government protection or player protection goals, owners should be given highest licensing priority.

B. Persons Entitled to Profits

Persons entitled to profits are parties that bargain for their goods or services to be paid for by a percentage of the other party's profits. In an online gaming environment, such profits will mainly be a percentage of revenues derived from player losses or rake. This is a sensitive area for gaming regulators because ownership interest can be easily disguised as a vendor's participatory interest in the gaming operation. The potential for abuse has led to some states, like Nevada, and some Internet gaming regulations to require anyone sharing in a percentage of gaming revenues to be licensed. For example, Antigua requires suppliers to be licensed if they receive a percentage of gaming revenues.⁸ This rule has the advantage of certainty and ease of application.

Still, the majority of profit participation agreements in the Internet gaming space are likely to be legitimate and consistent with existing Internet

⁸ Ant. & Barb. Internet Gaming and Interactive Wagering Regulations, pt. IV, §§ 87 (2007), available at http://www.antiguagaming.gov.ag/files/Antigua_and_Barbuda_Gaming_Regulations-Final.pdf

marketing practices. A good example of parties that might be entitled to share revenue are websites that drive traffic to the gaming site. Such affiliate marketing is widely used in the online retail space where companies that sell books, electronics, and clothing provide a percentage of each sale to the operator of the site that referred the customer to the seller. Other potential revenue sharers may include those who provide security software services, equipment, financing, or management.

Capturing revenue sharing affiliates in the licensing net disturbs the natural economy of Internet commerce. The effects can be twofold. First, sites and suppliers may alter their economic relationships by using formulas that are less reflective of the actual value of their services. For example, the value of a player referred by an affiliate is best measured by the player's losses. If licensing barriers obstruct this method of measuring and sharing value, a different and probably less efficient formula for compensation will have to be derived between the operators and affiliates. Second, fewer affiliates or suppliers may be attracted to the market, which may impact competitive pricing.

Governments that tend toward government protection goals are sensitive that allowing persons of unsavory reputation to share in revenues can damage the industry's reputation. For this reason, government protection goals and policies would counsel greater attention to the suitability of any parties sharing in profits.

Jurisdictions that tend toward the player protection goals are more concerned with the ability of profit sharers to influence operations based on their relationship to the gaming operator. As detailed in the section on level of review, regulators may decide to tier this group into smaller sub-groups for purposes of licensing review. One distinction could be based on the total revenue paid to a person. For example, are substantial regulatory concerns invoked if a poker teaching site is paid a nominal, monthly fee of a few thousand dollars based on a revenue share for recommending and referring players to a licensed poker site? Having different levels of licensing (or none at all) based on cumulative annual payments to vendors and suppliers is common in the gaming industry.

Another possible distinction is based on the nature of the entitlement. For example, a person that licenses a game patent and receives a percentage of the net revenues of that game may not have to undergo licensing, but a private person that finances the Internet gaming site and receives 20 percent of net profits may have to obtain a license. The reason is that a person who receives a small percentage of the revenue of one game is unlikely to have any significant influence over the site's operation. Exempting such parties from licensing would allow for the creation and promotion of new game content that is based on the game's real value to the gaming site.

In addition, relaxed standards may exist for persons sharing in overall revenues based on the nature of the transaction. An example of this may be where a finance company shares in revenues, and that type of sharing is typical of financing in broader contexts.

Elements of an Internet Gaming Site

Owner-Operated

White Labeled Site

Game Content

Sports Betting/ Exchange	Casino (RNG)	Poker (RNG)	Bingo (RNG)	Pari-Mutuel
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Backend Platform Software- System Backbone (API System)

Cashier	Fraud	Site Security	Account Management	Centralized Reporting Tools
Bonus And Loyalty	Registration Platform	Site Optimization	Customer Service	Affiliate/ Agent

Services (Requiring Integration Into Backend)

Payment Processors	Fraud Prevention	Age And Identification Verification	Location Verification
Affiliate Management	Network And Chat Management	Registration Services	Tax Allocation/Management Services
Security Services	CRM/Bulk Mail	Site Optimization	Customer Service/Call Centers

Hosting Services - Load Balancing

Site Services (Not Requiring Integration)

Domain Name Acquisition/ Management	Marketing Campaign Management	Audit/ Accounting	Banking	Legal
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Financial

Lenders	Creditors	Revenue Sharing
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As such, both government and player protection goals would prescribe policies for licensing at least some parties who share in the profits of Internet gaming sites. Still, there are notable circumstances where jurisdictions may consider a lower level (or no) licensing, including site affiliates who receive a small percentage of revenue for directing players to gaming websites, game patent holders who receive a portion of revenues that their games generate, and contexts, like financing, where revenue sharing is generally practiced.

C. Lenders/Creditors

Lenders/Creditors are common parties to most business agreements. Examples in an online gaming context could include lenders of money, suppliers of certain software, and vendors who sell equipment like servers or computers on credit. While licensing of every lender/creditor would ensure that people can neither hide ownership interests in online gaming operations nor exert undue control over operations, such regulation could be very costly to implement and regulate.

Four considerations surround the degree of regulatory scrutiny accorded creditors. First, creditors that lend money or provide financing expect a return on their money commensurate with the costs and risks involved in the transaction. Second, the initial cost of capital may decrease if the lender has the opportunity to share in revenues. Third, as the amount lent or financed increases, so does the creditor's vested interest in the success of, and potential influence over, the business. Fourth, unsuitable persons may use the cover of lender or creditor not as a method to lend moneys to a gaming operation at market interest rates but as a guise to participate in revenues from the gaming operations without obtaining necessary licensing. Regulation must balance the first and second considerations against the latter two.

Full licensing helps assure that loans are not used to hide ownership in gaming operations and that a party having potential influence over a gaming site is suitable. Requiring full licensing of all creditors, however, raises costs and creates barriers that will deter many legitimate lenders. This policy may result in higher interest costs to gaming operators since competition between lenders will be diminished and lenders will pass on investigation costs to borrowers. Likewise, vendors of equipment and goods may not be willing to provide goods on credit if it requires them to bear the expense of licensing. Such a regime would place the gaming operators in the position of having to either have cash available for purchases or seek loans from a limited number of approved lenders at interest rates potentially higher than the broader market.

Short of full licensing for all creditors, regulators can exempt certain creditors from licensing scrutiny. One possible exemption focuses on the difference between commercial and noncommercial creditors. There are four major types of commercial creditors: (1) banks or savings and

loan associations regulated by the government, (2) national insurance companies, (3) government-regulated pension or retirement funds, and (4) foreign-regulated banking institutions. Exempting commercial creditors from licensing is based on the idea that other government agencies regulate these lenders. These institutions would not likely violate controls prohibiting their involvement in gaming operations because it could jeopardize their other licenses. Moreover, because they are in the business of lending money, they spread their risk over many loans. Therefore, these institutions are less likely to feel compelled to influence gaming operations to protect their investment. Finally, the initial structuring of a loan with a commercial creditor is unlikely to be a scam under which the lender is actually an equity participant.

A second possible exemption is based on the extent and context of credit provided. This exemption recognizes that many transactions by noncommercial creditors are done in the ordinary course of business. This may include suppliers that ship their product, bill the gaming operator and expect payment within a certain time. Requiring the operator to prepay all suppliers or pay on delivery would burden gaming operators. Therefore, a standard can be set that exempts creditors from obtaining licensing when the credit extended is below a certain dollar threshold. For example, only creditors owed more than a certain amount may have to register with the regulators, and those over a higher amount must obtain a license.

A third possible exemption may be for transactions that are not secured by gaming assets, such as gaming receipts and gaming stock. This would recognize that lenders with certain security interests pose the greatest regulatory concern. These creditors have a substantial remedy against the gaming operator for failure to pay its debt. As such, a secured creditor of a financially distressed gaming operator can exercise much greater control over gaming operations than an unsecured creditor. This can also be addressed by requiring registration of secured interests, and giving them greater scrutiny than unsecured transactions. Another option is to require approval of secured transactions, but not necessarily a licensing investigation of the creditor. A third option is to require prior approval for the secured creditor to foreclose on a security interest in gaming equipment, gaming receipts, or stock.

Instead of granting broad exemptions, regulators may require the gaming operator to report all credit transactions. After reviewing the reports, the regulators would then have the discretion to require the creditor to file an application and undergo licensing. This allows the regulators to maintain control over the transaction with only minimal interference in financial markets. The mere possibility of having to obtain a license might result in some lenders refusing to serve the gaming industry, but will not be as significant an obstacle as mandatory licenses. Moreover, regulators can allay many concerns of potential lenders by judiciously exercising their discretion only when serious concerns arise.

Governments may be best served by taking a balanced approach to licensing lenders and other creditors. While full licensing would prevent hidden ownership interests and protect operators from the undue influence of unsuitable persons, such a licensing regime could result in higher costs for obtaining credit and a dearth in competition among creditors. There are several types of creditors which could be exempted from licensing requirements without undercutting governmental policy goals. Additionally, some jurisdictions may find that an *ad hoc* review of credit transactions is sufficient to insulate the Internet gaming industry from unsuitable or hidden interests

2. Key Game Suppliers

A. Operators - Hosted Service Providers

A white label product or service is a product or service produced by one company (the producer) that other companies (the marketers) rebrand (or “skin”) to make it appear as if they made it. Companies that provide white label services are Hosted Service Providers (called an xSP). These “turnkey” solutions are in essence a combination of Internet functions including gaming and non-gaming applications (Software as a Service), infrastructure, customer service, player hosts, web design and maintenance, regulatory oversight, security, monitoring, storage, and hosting email. Typically, the casino customer can brand the site through providing the art and audio for the site and are responsible for marketing the site. xSPs can provide different degrees of customization or permit the customer to assume responsibility for some aspects of the site. xSPs benefit from economies of scale and operate on a business to business model, delivering the same software and services to several casino customers, who may not have the economic incentive or expertise to operate their own Internet gaming service. Smaller casinos can also take advantage of the liquidity that a larger network can provide to its customers. When offering community based games, like poker, this assures the player has a variety of available games, limits, and, when offering house banked games, a wider array of games.

Hosted service providers should be given the highest priority in licensing breadth because of their importance in controlling the systems that assure the honesty and fairness of games, protection of player funds, and the other goals of both the players and government protection goals. While the profile of the hosted service provider may not, in many circumstances, be as visible as the actual owners, scandals or issues at such a level can harm players and significantly taint the industry.

B. Gaming Software Provider and Manufacturers of Internet Gaming Systems

Just as manufacturers of slot machines and other gaming devices are crucial in the operational ability of traditional casinos, manufacturers of gaming software are essential for an online gaming operation. Because such suppliers develop the machinery or code, suppliers can produce

flaws in the machine or imbed bad code which can compromise the honesty or fairness of the games. As such, online gaming operators and the government regulators need to depend not only on the integrity of the software maker, but also on the technical ability of the software maker to prevent future breaches of security and performance. Therefore, many governments specifically require software providers to obtain licenses. For example, in Alderney, an “associate” needs to be licensed.⁹ While “associate” might seem like it means “a business partner,” the definition of an associate includes a software contractor that designs the code.¹⁰ Alderney’s laws, in particular, have a wide breadth as they relate to what the jurisdiction perceives as a critical player protection function. In contrast, Antigua only requires key personnel to be licensed, which do not include suppliers such as software contractors.¹¹ In fact, suppliers need to be licensed only if they receive a percentage of gaming revenues.¹²

The extent to which a jurisdiction requires software providers to be licensed may depend on several factors. For example, the complexity of game software may go beyond the capacity of many regulatory agencies to understand or test. A sophisticated gaming laboratory is expensive; indeed, it can be more than the entire regulatory budget in many places. Jurisdictions without a testing laboratory may use private testing companies to fill the void. Either in-house or private testing may satisfy regulators that the design and operation quality of the gaming sites, and its myriad of functions, meet government standards. Even with a state-of-the-art laboratory, some aspects of Internet gaming sites are so complex that unscrupulous persons can still exploit them without detection. Regulators must therefore rely on the manufacturer’s integrity to assure that the gaming sites and the games thereon are fair and honest.

Licensing becomes more important to the extent that regulators do not have the money, expertise, or technical resources to assure that the games are fair and honest through testing and enforcement.

The manufacturer of the system platform may be different from the manufacturer of the game content. The issue in such case is whether to require licensure of both manufacturers. A jurisdiction may decide to only license the system platform manufacturer. This relies on the system platform manufacturer to have a contractual relationship with the game content providers and to exercise all necessary due diligence to assure that the game content software meets all regulatory requirements. The regulators are, therefore, relying on the honest and competency of system platform manufacturer along with an independent review of the software by an independent laboratory.

⁹ Alderney, The Alderney eGambling Ordinance § 17 (2009)

¹⁰ *Id.* at § 30, “business associate.”

¹¹ Ant. & Barb., *supra* note 8 at pt. II, § 10 (persons requiring licenses); pt. I, “Key person(s) (defining key person); pt. IV, §§ 87-8 (suppliers and licensing).

¹² *Id.* at pt. IV, §§ 87, 88.

Another issue is the history of the software. Other non-licensed developers may have touched the code in the past. Software is a living, breathing entity and code is rarely derived from the ground up. Moreover, with software increasingly being coded by team members or third party contractors in various remote locations, governments cannot guarantee the code has only been handled by licensed resources. Therefore, governments need to rely more heavily on the accountability of licensed operators, systems architects, and potentially the test labs to be accountable for the integrity of the integrated code in its current and future configurations.

A subset of game software is the random number generator, which is the core of many game systems. This is the software algorithm that generates a sequence of numbers or symbols that lack any pattern, or appear to a testable degree to mimic a random event. Malta and other legislations typically certify a number of RNG producers and require licensees to use only a certified random number generator.

3. Non-Gaming Related Services And Software

A. Application Service Providers.

An application service provider (ASP) is an Internet based business service. The ASP typically provides software application, operates and maintains the servers, and offers the Internet service through web browsers, mobile devices, or otherwise. Even a gaming company that intends to own and operate its own Internet gaming site contracts certain services to third-party ASPs for services such as payment processing, geo-location, age and identification verification, or customer relations management. The reason for such integration with third-party services can be that the Internet site lacks expertise in a particular service area or it is much less expensive to contract for the service than to provide it directly. Some risk, however, exists in integrating some services including the loss of control of corporate data and potential security risks.

The extent to which ASPs should fall within the breadth of licensing should depend on the type of service being provided.

1. An Application Programming Interface (API) Provider

In this context, the API is the supplier of a complete interface for multiple software components to communicate with each other. In Nevada, these platform providers are tasked with greater responsibility than merely a component provider to an operator. They are tasked with assuring that all gaming components on the system meet regulatory requirements. In this context, the regulators require them to obtain a license. Without delegating this additional authority, the API provider could be no differently than another software provider whose software does not determine win or lose.

In jurisdictions with higher levels of technical resources and competency, licensing may be less important than those jurisdictions where the honesty and competency of the manufacturer is more critical.

2. *Payment Processors*

Internet gaming sites can process payments directly with their bank, called the merchant bank. In this case, the site will apply for and obtain a merchant account. This allows the site to accept credit/debit cards, and other forms of card payment based on the card not present (CNP) transaction principles. A payment processor typically is a third-party company appointed by a merchant to handle credit card transactions for merchant-acquiring banks. Most payment processors act as “middleman” where the player pays the processor, which in turn pays the site less a processing fee. Besides securely transferring the money between the various bank accounts, the payment processor can provide other services including anti-fraud and anti-money laundering measures, as discussed below.

Advantages to using a payment processor can include increased security, fraud prevention, and lower system infrastructure costs (such as purchasing or developing a payment gateway). A large payment processor may allow the gaming site operator to utilize credit card merchant facilities with multiple premier banking institutions with preapproved mainstream payment mechanisms such as PayPal, Visa or MasterCard.¹³

Payment processors are largely unrelated to the major policy goals of both player and government protection. For example, a payment processor has no opportunity to cheat the player or impact the honesty or fairness of the games offered on the site. Payment processors may, however, handle player payments and receipts. In this process, some payment processors may have custody of player funds. The policy goal of assuring that these funds are adequately protected is consistent with both player and government protection goals. This can be achieved in several ways short of requiring licensing of the payment processors. The first way is to require the site owner to have reserves in place even for funds in temporary possession of the payment processor. If this is done, even if the payment processor absconded with the funds, the players would be protected. A second method would be to require the payment processor to bond or otherwise insure the moneys in their possession. A third method is to regulate the accounts that the payment processor is using to assure that they are properly restricted. This can include procedures and approvals for segregation of players' funds outside of operators' control. Two or more trusted third parties, which could include the payment processor, regulated financial institutions, and regulated escrow agents or insured

¹³ The use of ewallet structure versus aggregate accounting structure present different software bookkeeping and controls. Ewallets, as an example, tie to a user's social security number. Nevertheless, fraud and anti-money laundering controls are typically written into the software system layer.

certified accountants, could share control of the segregated funds. In any of these cases, enforcement mechanisms may assure better policy results than interfering with market competition through licensing.

Besides the security of players' funds, the government may have legitimate concerns as to whether the payment processor can adequately protect player data. This may be addressed through technical standards or by reference to third party data protection standards. For example, major credit card companies adopted PCI (Payment Card Industry) compliance standards for financial institutions and merchants that secure customers' personal data when using a credit card. As a matter of practice, Malta requires that all payment processors be PCI compliant.

Payment gateways are different from payment processors in that a payment gateway merely facilitates the transfer of information between the Internet gaming site and the player's bank (called the issuing bank). A key function of a payment gateway is encryption. A payment gateway uses encoding technology to encrypt and decrypt all the transferred information, including credit card numbers and other account information. The payment gateway processor validates the provided card account details and authorizes the payment amount. It is probably more significant to note what the payment gateway does not do. It is the card issuer that transfers the funds directly from the player's card balance to the acquiring bank. The acquiring bank then transfers the funds into the Internet gambling site's own merchant account. Payment gateways should have low priority because they have no direct effect on any policy goals regardless of whether the focus is on government or player protection.

Payment processors and payment gateways are a useful, and in many cases essential, tool for online gaming sites to securely and efficiently transfer funds. Because these systems are uniquely removed from many of the government and player protection goals discussed in this chapter, licensing them is not an especially pressing matter. In fact, enforcement mechanisms and other non-licensing, regulatory requirements are likely sufficient to ensure that governments and players are adequately protected from the risks associated with payment processors and payment gateways.

3. Fraud Prevention

Fraud prevention consists of fraud screening techniques designed to maximize the efficiency of the payment verification process. It is often conducted by the payment processor as a part of the services that they provide to online sites. These techniques can involve address verification (comparing the address information provided by the player against the billing address information that the issuer has on record for the account), card verification methods (to ensure that the person submitting the transaction is in possession of the actual card), comparison of data in positive and negative files (Office of Foreign Assets Control list lookups or 'black-list' lookups),¹⁴ and conducting

¹⁴ According to the official US Treasury website, the Office of Foreign Assets Control

risk analysis based on IP address, country of origin, and velocity pattern analysis.¹⁵ In most cases, the provider that offers fraud prevention services does not decide whether to accept or reject a transaction; rather if the fraud criteria set by the operator and administered by the service provider indicates an exception, the transaction is referred to the operator for resolution. In such cases, the service provider is further removed from responsibility for decisions that could impact revenues and hence, less important to achievement of policy goals; therefore the benefits of licensure are greatly reduced.

4. Site Security

Site security is a very broad concept and can entail many aspects including network management, site redundancy, firewalls, intrusion detection, intrusion prevention, hacking prevention, social engineering, anti-virus, anti-Trojan, anti-worm, physical security, a secure uncrackable RNG, and disaster recovery. Certain forms of hacking, such as Denial of Service attacks¹⁶, that cannot cripple a brick-and-mortar casino, would prevent the gaming operation from operating and can cause serious damage to an Internet-based gaming operation. This can be of special concern for jurisdictions that focus on government protection goals as it can impact tax revenues and the public perception of the sufficiency of the regulations. Moreover, from a player protection perspective, compromised site security could allow hackers to steal personal player data or impact the fairness or honesty of the games. Thus, site security is an important aspect of regulatory oversight. It may, however, be more appropriately the subject of technical standards and regulatory enforcement as opposed to licensing.

Site security is important to all Internet commerce from small businesses to multi-billion dollar banking institutions. The methods that each uses to protect their sites can be, and often are, state of the art solutions. Isolating who can provide services to the gaming sites based on licensing will likely prevent the gaming sites from always using state of the art security services

“publishes a list of individuals and companies owned or controlled by, or acting for or on behalf of, targeted countries. It also lists individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. Collectively, such individuals and companies are called “Specially Designated Nationals” or “SDNs.” Their assets are blocked and U.S. persons are generally prohibited from dealing with them.” <http://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx>

¹⁵ Velocity pattern analysis is a method of determining the potential of fraud in an online transaction based on the number of uses of a data element such as the use of a credit card in a predefined period such as 24 hours. A sudden increase in the number of transactions can signal the greater likelihood of a fraudulent transaction. <http://www.merchantaccount.at/processing101/antifraud/velocity-pattern-analysis/>

¹⁶ “A Denial of Service attack (DoS) is any intended attempt to prevent legitimate users from reaching a specific network resource.” George Loukas and Gulay Oke, *Protection against Denial of Service Attacks: A Survey*, THE COMPUTER JOURNAL, Volume 53, Issue 7, page 1, Oxford Journals, <http://staffweb.cms.gre.ac.uk/~lg47/publications/LoukasOke-DoSSurveyComputerJournal.pdf>.

and software needed to ensure the security of the site from hackers and other external threats.

5. Age, Identity, and Location Verification Systems and Services

Age and Identification verification refers to systems or services used by Internet gaming sites to confirm that the users attempting to access their website are who they claim to be and are of the age required by law to participate in gaming. This service involves the documenting, tracking, and logging of identification and age verification. Age and identification verification providers also interface with age and identification databases provided by 4th parties, including other governments.

Location verification refers to systems or services sites designed to confirm that the users are physically located in a jurisdiction where they are permitted to play and where the site is permitted to accept players. This service involves documenting tracking and logging of location verification.

Both age and location verification systems are widely available and used in a variety of existing online businesses. For example, both age and location verification are important for Internet sales of alcohol and tobacco products as well as age-restricted materials. Allowing Internet gaming sites to use existing technologies without placing substantial licensing barriers on providers assures that the most technically advanced technology is available to the operator. This is particularly important for compliance with the laws of other jurisdictions. The need to license age and location verification services is further diminished where regulators set reasonable standards for age or location verification systems or services. Reasonable regulatory standards would include privacy protections and the parameters for how the operator should determine who meets relevant age and location requirements at both the automated systems level and when exceptional circumstances require non-automated verification.

6. Bonus and Loyalty Management

Bonus and loyalty management software and services allow the Internet site to measure customer feedback and allocate resources including bonuses based on the customer loyalty. These systems include customer loyalty metrics that measure and aggregate a customer's loyalty, track ongoing customer feedback, and provide methods for utilizing that information, including player bonuses based on the data and feedback collected. To the extent that third party service providers can access player data or can interface with game systems, regulatory oversight may be useful. To the extent that these concerns can be addressed through technological standards, the need to invoke licensing or registration may be diminished. Where third parties do not have access to either game systems or player data, responsibility for bonus and loyalty management systems can legitimately lie exclusively with the licensed operator.

B. Internet Hosting Services

An Internet hosting service allows individuals and organizations to make their website accessible to players. Web hosts are companies that provide space on a server for use by clients, as well as Internet connectivity, typically in a data center. Web hosts can also provide data center space and connectivity to the Internet for other servers located in their data center, called co-location. In this scenario, the user owns the server; the hosting company provides physical space that the server takes up and takes care of the server. The co-location provider may contribute little to no support directly for their client's machine, furnishing only an environmental control system, uninterruptable power supplies, battery backups and diesel generators, Internet access, and secured storage facilities for the server.

Hosting service plays two important roles of concern to regulators: security of the site servers and uninterrupted service. Private certification of a data center is made based on the level of capability of the data center, with the highest tier (4) being the most redundant capacity components and multiple distribution paths serving the site's computer equipment and, thus, least likely to have interrupted service. Security of the data centers can also vary from insecure to meeting the highest standards for critical government and banking servers. As governments are more likely to want licensees to use the most secure and robust data centers, as opposed to self-housing their servers, they may want to regulate the use of third party co-location data centers through technical standards and enforcement rather than by licensing.

C. Independent Marketing Agents, Affiliates and Other Referral Websites, Agents, and Virtual Hosts.

Search engines, e-mail, website syndication, and marketing affiliates have long played an important role in driving customers to Internet gaming sites. Some sites have more than 70 percent of their revenue coming from affiliates.

Affiliates of an Internet gaming operator are entities that are paid to bring customers into the gaming operation's web portal. Usually, affiliates are websites that have business arrangements with the gaming operation in which the affiliates agree to connect their users to the gaming website. For example, a gaming news website that directs its members to the casino would be considered an affiliate. In return, the affiliates are compensated for their referral by either a fixed fee per referral or a percentage of the expected gaming revenue derived from each referral. In the realm of Internet gaming, affiliate websites perform the roles that junket representatives¹⁷ and hosts perform in traditional casinos. Affiliates do not know or have access to the revenues that a gaming operation generates. In fact, the only time that

¹⁷ A junket representative is a commissioned contractor that bring patrons to the casino. ANTHONY N. CABOT, CASINO GAMING: POLICY, ECONOMICS, AND REGULATION 254 (2001).

affiliates have a connection with the gaming operations of a website is when affiliates are paid a percent of actual gaming revenues.

Advertisers are external entities that work with the marketing department within the gaming operation to promote the gaming site. The very purpose of the advertiser is to stimulate demand for gambling on the licensed site. An example of such an entity is a company that posts advertisements, known as banner ads, on various web pages. These ads are posted for the gaming operation in return for a fee per view or a fee per click. The largest groups of online advertisers include search engines and social media websites. Rather than affiliates who might be paid an estimated or actual percent of gaming revenues, advertisers in the online world are generally paid per click. Several common methods exist to compensate marketing affiliates including revenue sharing or pay per sale (PPS), cost per action (CPA), and cost per click (CPC) or cost per mille (CPM). As the name suggests, cost-per-click advertising means that the advertisers put the gaming operation's advertisements on many websites to gain potential clients, and the gaming operation pays the advertiser once a prospective gaming customer clicks on the advertisement and is directed to the gaming operation's website. Advertisers are fairly isolated from gaming revenues and the gaming operations. CPA arrangements typically pay the affiliate (a) a flat fee for each registered player, (b) a flat fee for each registered player who makes a deposit, (c) a percentage of the gross revenue of a player, or a combination of (a) plus (c) or (b) plus (c).

Regardless of whether a jurisdiction's policies focus on government or player protection, the use of affiliates poses certain concerns.¹⁸ Unlike casino employees, affiliates act independently of the gaming site. This creates less accountability to corporate codes of ethics and internal controls. Affiliates can serve as "barkers" whose sole goal is to drive traffic to the gaming sites. This can be done through the use of false or misleading advertisements or offers. For example, a site may pose as an independent consumer review provider, while actually giving falsely positive reports and ratings to only those sites that pay them bounties. Moreover, the affiliates can operate beyond the jurisdiction of the regulators.

Site operators must adopt corporate policies if they want to control affiliate behaviors. Regulators can shift the responsibility to maintain regulatory controls over the affiliates to the site operators through mandatory policies and practices that can be reviewed and measured by regulators if desired. Moreover, technologies exist to help control affiliates. Governments can implement "crawler" software, that can collect data on the marketing activities of the affiliates of their licensees. If violations of advertising standards are detected, then the regulators can force the termination of the affiliate relationship or take other corrective action. While potentially effective, this method is reactive as opposed to proactive.

¹⁸ Under the most conservative player protection goals, the use of affiliates to promote gaming activities could be prohibited as it stimulates demand.

Internal marketing employees pose fewer problems than affiliates because they are subject to corporate codes of ethics and internal controls.

D. Operation and People Services

Other services such as customer service, domain name acquisition and management, affiliate management, network and chat management, and site optimization are not critical to the core policy goals related to either player or government protection. Regulators may want to understand the interface of these systems with more critical system functions or the extent of access to customer data. Only where technical requirements cannot adequately protect critical systems should consideration be given to requiring registration or licensure of these types of providers.

E. Non-Gaming Software Providers

Among others, gaming site operators may use products that integrate into back-end gaming platforms to perform such functions as account management, affiliate and agent software, customer relationship management tools, fraud and security tools, registration platforms, integrated cashier, centralized reporting tools, bonus and loyalty tools, network management tools and site optimization tools.

Recommendation

As detailed above, the necessary breadth of licensing is highly contextual. Apart from owners and hosted service providers, which should be given the highest licensure priority, the need for licensing depends greatly on the extent to which a party can influence a variety of factors like the honesty and fairness of games, the public's perception of the online gaming industry, a party's ability to affect gaming operations, the economic and innovative costs of licensing requirements, and whether licensee oversight, technical requirements, and regulatory enforcement sufficiently protect against risks related to malfeasance or incompetence. More simply, the breadth of licensing will vary based on a jurisdiction's particularized policy concerns and its ability to adequately address those policy concerns through methods other than licensing.

Depth of Licensing

When a government requires a license to engage in gaming-related activities, the entity that must apply for and obtain a license often is not an individual. For example, the owners of most Nevada casinos are publicly traded corporations. Depth of licensing refers to which persons associated with the applicant-entity must file an application and obtain a license.

Regardless of the type of approval sought, it is first necessary to determine which parties associated with the applicant need to be licensed. Jurisdictions around the world have varying requirements as to who within or associated with an applicant needs to be licensed. Decisions on

who must be licensed are based mostly on the relationship between the party required to be licensed and the applicant-gaming operation. For example, in the Isle of Man, for the business' gaming license to come into force, a designated official of the company must first be approved by the Commissioners.¹⁹ Thus, determining the depth of who needs to be licensed requires an analysis of the involvement of parties in the management and operations of the online gaming operation. Many jurisdictions require significant depth in terms of who needs to be licensed.

Most owners, operators, suppliers, and vendors for Internet gaming sites will be some form of business entity, usually a corporation. A corporation is an artificial person or legal entity that the government authorizes to conduct business. The principal benefits of a corporation are the limited liability of equity owners (known as shareholders), transferability of interest, and continuity of existence.

Structures for corporations differ between countries, but usually involve officers, directors, shareholders, and employees. Shareholders are persons or entities that hold equity, as represented by shares, in a company. Shares entitle the holders to control the corporation through voting for the board of directors. In the discretion of the board of directors, shareholders are entitled to earnings through current or accumulated dividends and to pro-rata distribution of assets upon liquidation.²⁰ Shareholders typically elect directors who manage the corporation through corporate officers. Officers are corporate agents, and have management responsibilities that the board of directors delegates to them.

Depth of licensing for corporations concerns which directors, shareholders, officers and employees must undergo licensing scrutiny. Similar considerations are needed for other business formations, such as general and limited partnerships, trusts, joint ventures, limited liability companies, and joint stock associations.

1. Officers/Key Employees

Gaming executives are responsible for overseeing gaming operations. One gaming executive that is particularly critical to gaming operations and the well being of the Internet gaming company is the Chief Executive Officer (CEO). The CEO manages all online gaming operations, ensures efficiency of the website, and establishes internal policies and rules. Sometimes, an online gaming portal may divide the CEO's responsibility into two: the CEO would have the role of managing the business aspects of the gaming operation, and an employee with specialized technical skills, known as the Chief Technology Officer (CTO), would manage the site itself. Among the CTO's responsibilities are to ensure that the site is

¹⁹ Isle of Man, Online Gambling Regulation Act § 10 (2001), *available at* <http://www.gov.im/lib/docs/gambling/Regulations/onlinegamblingregulationact2001.pdf>

²⁰ HARRY HENN AND JOHN ALEXANDER, CORPORATIONS (HORNBOOK SERIES) 396 (1983).

always accessible, that it is secure, that it can sustain anticipated traffic, and that the software and hardware implemented meet regulatory and internal standards. Other important technical persons include the chief architect and chief systems administrator. System administrators play a significant role in site security. They can govern everything from safety of the operating system to new software versions. The Chief Financial Officer (CFO) is typically responsible for managing the financial risks of the corporation, budgeting and financial planning, record-keeping, financial reporting, and data analysis.

Since executives have access to nearly all of the gaming operation's financial information and have the ability to manipulate the data, they are the group most likely to receive regulatory attention and intensive licensing review. Regulations can designate these individuals in different ways. For example, the Kahnawake, a Mohawk Territory in Canada, designate the titles of key officers that must be licensed including the CEO, CFO, COO, CTO and Office Manager.²¹ In Malta, regulators require licensed directors to be Maltese residents.²² Other jurisdictions designate who needs a license based on function as opposed to title. For example, the United Kingdom requires that key personnel be licensed, but defines key personnel based on function rather than title.²³ Those functions include anyone responsible for the overall strategy of gaming operations, financial planning, control, budgeting, marketing, commercial development, regulatory compliance, IT provision, and gaming related security.²⁴ Still others use compensation to determine who needs a license by either setting a compensation amount that triggers licensure or simply requiring a fixed number of the most highly compensated executives to file an application.

Regardless of whether they are defined by job title, function, or compensation, corporate agents performing essential functions are likely to be subject to some degree of licensing in most jurisdictions.

2. Other Employees

A. Hardware and Software Technicians

Software engineers are some of the most numerous employees of an online gaming operation. Led by a chief software engineer, the role of software engineers is to write computer code that will impact every aspect of the website. The most common types of code that the engineers focus on are code directing the randomness/probability of casino games,

²¹ Kahnawake, Regulations Concerning Internet Gaming, §§ 60-62 (1999) (amended 2011), available at <http://www.gamingcommission.ca/docs/RegulationsConcerningInteractiveGaming.pdf>

²² Malta, *supra* note 6 at § 2 "key official," 15, 18.

²³ Gt. Brit. Gambling Act, Pt. 5, §§ 67, 80 (2005), available at <http://www.legislation.gov.uk/ukpga/2005/19/contents>

²⁴ *Id.* at § 80.

code to direct the movement of money between accounts, and reporting functions. Although the group, also known as computer programmers, might seem as if it has the ability to markedly impact gaming operations, software engineers are not heavily involved while the gaming operation is functional. The programmers' role of writing code is undertaken offline and is verified by multiple parties, internal and external, before the software is implemented in a live setting.

Governments need to understand their own resources and the limitations of testing strategies even when performed by independent testing facilities. While controls over the software can be implemented to ensure that the computer code is fully functional and that no avenues exist for the programmers to insert malicious code that would change probabilities or transfer funds to incorrect accounts, these things cannot be accomplished with absolute guarantees. The degree of assurance is dependent on many factors including the stringency of the standards, the quality of the manufacturers' internal testing and controls, the competence and capability of the testing agency, and the degree and sophistication of the government's industry-wide oversight. Once the software is implemented into the operations, except for follow up releases and bug fixes, software engineers are not involved; the technical operations personnel take over the role of managing the software.

Although an online gaming operation does not have a physical location, the website runs off certain hardware. This hardware is comprised of servers and hosting computers, which are managed by information technology employees with expertise in the field. This group is perhaps farthest removed from gaming operations because hardware employees typically do nothing more than monitor the physical components used to run the website, and not the software upon which the website operates.

B. Technical Support and Operations Personnel

In the ecommerce world, technical support staff is often broken into levels. Level 3 personnel would be highly trained technical system administrators and support engineers. Key individuals in this group are discussed above. Level 2 personnel would have some technical knowledge but much less than Level 3. Level 1 personnel are not very tech savvy but interface with the customers. Most important for the purposes of regulatory licensing is not the personnel level but the functionality and access assumed by each level of technical support staff. For example, technical operations personnel are a subgroup of technical support that is unique to Internet gaming. This group is responsible for ensuring that the website is operational and that it is secure. A major role of technical operations personnel is to monitor the website and ensure that it is safe for players, that there is no cheating, and that the integrity of the gaming operation is not compromised. To meet the responsibilities of this function, technical operations personnel are given very broad access and have the

ability to move funds into or out of client accounts, to monitor and change game outcomes, to contact clients regarding their accounts, and to access the funds of the gaming operation to settle monetary disputes. Due to the ability of this group to access and change sensitive information, it should have exposure to stringent licensing requirements.

Therefore, the level of system access a particular job function requires should dictate which technical support personnel need to be licensed and not the job's level of technical knowledge.

C. Customer Support

Customer support employees, in any business, are meant to interact with customers and resolve any issues the customers face. In Internet gaming, some common customer service roles include providing information about the website to potential clients, knowing the games offered, and settling client disputes with the gaming operator. In the long-run, effective customer support can help the website achieve a reputation for being user-friendly, which will certainly help the business. To perform effectively, customer service employees need access to information that might be sensitive.

To solve some of the more sensitive customer issues, such as those involving funds, customer support may need to access private information, like information regarding customer funds and bank accounts. Furthermore, to settle disputes, customer support may be able to move a limited amount of funds either to or from player accounts. Much of this may depend on whether payment processing is outsourced and whether sensitive data is available only to the payment processor. Although this group has access to sensitive customer information, the regulatory need for strict licensing of the group is not high because the actions of customer support can be traced and, if necessary, reversed. Additionally, much of the information that is available to customer support is on a read only basis, which means that customer service employees can view, but not change, the information. Nevertheless, depending on the functionality and access accorded to customer support, governments may consider some limited form of licensing for customer support such as employee registration or work cards.

D. Fraud and Surveillance

The fraud and surveillance department of an online gaming operation seeks to prevent players from cheating both the gaming operation and other players. The department, led by the director of surveillance, monitors games and their outcomes in order to determine the probability that players are using software to cheat the gaming operation. By looking at the risk/returns of many games, the fraud department can also detect players who are banning together and bilking other players out of money. Another key function of the fraud and surveillance department is to prevent fraudulent

forms of payment. As identity theft and credit card fraud rise, the burden on the department to verify payments rises so that the gaming operation and other players can be awarded their winnings.

Along with the functions of a traditional casino, such as monitoring games to prevent collusion among players, the online frontier imposes many additional duties on the fraud and surveillance department. For example, the department monitors the website for collusion, chip dumping, and robotic programs. The fraud and surveillance department also ensures that the users of the site are real persons.

The main tool that the department has to enforce its anti-cheating and -fraud measures is exclusion. Just as traditional casinos can remove players from the property, the fraud and surveillance department of an online gaming operation can exclude a player from participating in the website's operations.

Generally the department has read-only access. Thus, while the director of surveillance has access to information that would make him critical in gaming operations, the access is not one that can be used to manipulate gaming data. As such, the need for licensing in the fraud and surveillance department is not particularly compelling.

E. Marketing Employees

The marketing department of a gaming operation is responsible for the creation and implementation of a marketing strategy to drive traffic to and promote the gaming operation. In the context of Internet gaming, a marketing director leads the marketing department and works with affiliates and advertisers to seek more customers. Some key roles of the marketing director include developing promotions, installing rewards programs, and ensuring that the gaming operation's image is not undermined in the media. The marketing director is also responsible for ensuring that all marketing strategies and all interactions with affiliates, advertisers, and potential customers comply with all relevant gaming statutes and regulations.

In Internet gaming, marketing employees are responsible for some unique tasks. For example, the marketing department of an online business has to monitor online activity targeting the gaming operation. Search engine optimization, social media marketing, and banner advertisements on websites are some of the common functions that an online gaming operation's marketing department performs. All such roles, while not directly related to the gaming operations, indirectly influence the revenues of the gaming operation.

Internal marketing employees pose fewer problems than affiliates because they are subject to corporate codes of ethics and internal controls. Because they are employees, gaming site operators have greater interest and control over their actions. Because licensee oversight is likely sufficient to ensure marketing employees do not contravene a government's Internet gaming regulations and policies, licensing is largely unnecessary.

F. Finance and Accounting

The finance department of a gaming operation, led by the Chief Financial Officer (CFO), makes financing decisions such as issuing debt, ensuring compliance with regulations, and monitoring projects to generate positive cash flows for the gaming operation. The accounting department is led by the gaming operation controller. It is the duty of the controller to reconcile accounting transactions, enforce internal controls, approve the general ledger, and work with the internal audit department to monitor money flows. Together, the finance and accounting departments maintain the gaming operation's financial records, prepare licenses and tax forms, and balance the gaming operation's books.

Although the two departments seem to have access to much of the gaming operation's financial records and bank accounts, the access is very limited. The employees of the two departments can view the financial information, but generally cannot alter the data. Furthermore, internal policies are in place to prevent the employees from transferring any of the gaming operation's funds into other accounts. Thus, the departments are not deeply associated with actual gaming activities. Because their duties are primarily post-gaming (i.e. journaling entries, reporting results, etc...) licensure is not especially pressing.

G. Internal Audit

The role of the internal audit department is to analyze and verify the gaming operation's transactions to ensure that they meet established regulatory and internal guidelines. Internal auditors, led by the director, also determine if the various gaming departments are following accounting rules, custodial policies, and control procedures. While internal auditors are focused on the workings of gaming departments, audit clerks audit revenue generating areas. Audit clerks verify the accuracy of revenue and expenditure figures, correct discrepancies, audit online balances, and prepare reports about daily operations. The internal audit department seeks to verify information post-event and so is not directly involved in actual gaming operations. As with the financing and accounting departments described above, the audit department's post-gaming role greatly mitigates the need for licensing.

H. Non-Gaming Employees

A website needs to hire employees for non-gaming purposes. For example, a website could have employees that manage its servers and decide which types of games to offer players. Such roles are isolated from the actual game play and therefore need not be licensed.

Notable exceptions are computer information service employees. As gaming operations become more computer-based, the staff dedicated to the maintenance of these systems increases. A gaming operation can have many different sensitive computer systems, including player tracking systems, slot tracking systems, debit card systems, marker issuance and

collection systems, bingo and keno systems, accounting systems, and sports and horse race totalizers.²⁵ Such employees may have greater opportunity to manipulate game outcomes or player/operator accounts.

Except for certain computer service employees, non-gaming operation employees generally are of the lowest regulatory priority. Effective implementation of internal control systems should adequately protect gaming operator assets from potential theft by non-gaming employees. Regulators, however, may wish to make computer service employees, particularly those with access to software, a higher regulatory priority.

3. *Directors*

Directors have a duty to the corporation to use their best judgment in deciding and executing corporate policy. Their duties include (1) selecting officers and setting officer salary and compensation, (2) making major policy decisions, and (3) deciding major financial matters, including dividends and financing. Directors often are described as inside or outside directors. An “inside” director is a board member who is an employee, officer, or significant shareholder in the company. An “outside” director is not an employee, significant shareholder, or otherwise charged with operational responsibilities; an “outside” director is considered independent of management. Outside directors can be selected because of their general business or specific industry knowledge or experience. As a result, outside directors are often viewed as having objective, informed opinions regarding the company’s decisions, health, and operations and bring diverse experience to the company’s decision-making processes.

Governments often only require inside directors to obtain licenses. In Nevada, as an example, only inside directors of public and certain private companies have to file licensing applications.²⁶ They include the chairman of the board, those holding greater than five percent of any class of voting securities, those serving on the executive committee or any comparable committee with authority over the casino activities, those who are also gaming employees, and those who regulators determine supervise gaming activities.²⁷ This is a reasoned approach because outside directors are independent of the company and have less opportunity to impact daily management or operations most subject to regulatory sensitivities.

²⁵ A totalizer is a computer used in pari-mutuel horse race wagering to register and divide the total of all wagers made after the race track has subtracted its commission among all the persons having placed a wager on a winning horse or combination of horses. See Princeton’s Wordnet.

²⁶ Nev., Regulations of the Nevada Gaming Commission and State Gaming Control Board, §§ 5A.030 (licensing regime for Internet gaming mirrors traditional licensure), 15.585.7-5 (corporate licensure requires that any person described in 16.410-15 have a license), 16.410-15 (licensing officers, employees, and directors) (1959) (current as of March 27, 2012), available at <http://gaming.nv.gov/modules/showdocument.aspx?documentid=2957>

²⁷ *Id.*

Moreover, as outside directors are most often paid based on fixed criteria such as a monthly or meeting fee, they are less subject to financial or other pressures that could lead to compromising regulatory integrity. Finally, a goal of selecting outside directors is to have the most qualified persons to serve in that position. The pool of eligible outside directors would likely be significantly smaller if licensing were a prerequisite.

4. Shareholders

All forms of business entities that a license applicant may use include the concept of equity ownership. In corporations, the most common form of business entity is equity held by shareholders. A corporation can be either public or private. A publicly-traded company is a corporation whose stock is traded on a public market. An attractive feature of being a publicly-traded corporation is the ability to raise capital through a public offering. Most often, a public offering occurs when the company sells either stock or debt instruments to the public through brokers. Public company stock is attractive to investors because it usually provides liquidity. If a person buys the stock, he can usually sell it in the public market by simply contacting his broker.

Benefits aside, allowing publicly traded corporations to own and operate gaming operations poses regulatory issues. As a practical matter, a publicly-traded corporation cannot be licensed if all its shareholders must be licensed. A public company can have thousands of shares traded daily. Therefore, if a jurisdiction wants to encourage publicly-traded corporations to invest in its gaming industry, it must allow licensing without each shareholder having to obtain a license.

Waiving licensing requirements for some shareholders, however, may allow unsuitable persons to buy shares and have an ownership interest in the gaming companies. This may not pose substantial problems if the person owns a few shares out of millions, but can create regulatory issues if the person owns a significant percentage of the stock. Public perception problems may occur where the media exposes that a notorious criminal has major holdings in a publicly-traded gaming company. Moreover, regulatory problems may occur where the person's holdings allow him to exert influence or control over the corporation.

Jurisdictions that want publicly traded corporations must balance these regulatory concerns with market realities. They can do this by setting thresholds at which shareholders in publicly traded corporations must apply for and obtain a gaming license. In the United States, these levels are commonly set at 5 percent, 10 percent, or 15 percent.²⁸ As an example, a license application may ask the applicant to name and provide a curriculum vitae of every shareholder that holds more than 5 percent of the company. These levels are often tied to government reporting or filing requirements for when a shareholder acquires a beneficial interest greater than a certain

²⁸ CABOT, *supra* note 17, at 275.

amount. Some places, such as Nevada and New Jersey, allow institutional investors to hold over 10 percent.²⁹ Institutional investors are entities such as banks, insurance companies, registered investment companies, advisors, and employee benefit or pension funds. Falling within this category are mutual fund companies that often control and invest billions of dollars for their clients. In Nevada, the regulators set a maximum limit that an institutional investor may hold without obtaining a license.³⁰ In both Nevada and New Jersey, the institutional investor must show it is holding the stock for investment purposes only.³¹

Some jurisdictions do not distinguish between private and public companies and set levels for shareholder licensing based solely on percentage of ownership. For example, Kahnawake requires the suitability of each individual who owns more than 10 percent of outstanding shares,³² while Antigua sets the bar at 5 percent.³³ The historical experience of some jurisdictions has provided little reason to distinguish between public and private companies. These jurisdictions licensed gaming before the advent of public gaming companies. They made general exceptions to the requirement that all shareholders be licensed to allow public companies to enter the industry. This limited relaxation of regulatory oversight was deemed an acceptable tradeoff for the benefits brought by public company investment. The requirements were not relaxed for private companies. Even Nevada, however, has since relaxed requirements that all shareholders of private companies must obtain a license.

Therefore, typically the need for licensing shareholders is linked to the extent of that shareholder's investment. It is important to note that the nature of institutional investors may allow them to avoid licensure where individuals may not. Another important regulatory consideration is whether a company is public or private, since requiring all public shareholders to carry a license is a practical impossibility.

Levels of Review

Levels of review in regulatory systems consist of "tiered" licensing. Tiered licensing involves categorizing groups of individuals or entities that are associated with the gaming industry into two or more tiers. Each tier is then subject to a different level of licensing scrutiny. For example,

²⁹ Nev., *supra* note 26, at § 16.430(1) (for public companies) and at § 15.430(1) (for private companies); N.J. STAT. ANN. § 5:12-85.1(g) (West 1977) (current as of Feb. 1, 2011)

³⁰ Nev., *supra* note 26, at § 16.430(1) (for public companies) and at § 15.430(1) (for private companies).

³¹ *Id.* at § 16.430(1, 3) (for public companies) and at § 15.430(2) (for private companies); N.J. STAT. ANN. § 5:12-85.1(g) (West 1977) (current as of Feb. 1, 2011)

³² Kahnawake, *supra* note 21, at §§ 24(b)(iv) (traditional gaming context), 30(d) (Internet gaming context).

³³ Ant. & Barb., *supra* note 8, at pt. II, §§ 10(b), 16, 17.

regulators may decide to extend the breadth of licensing to both owners and gaming employees. The level of review, however, might be different. Owners may have to undergo a thorough investigation that requires the regulators to spend months reviewing all aspects of the owner's life, while the review of the gaming employees is merely a check of their police records. These checks take on several forms depending on the jurisdiction. In Malta, the licensing authorities review personal background information, financial information, participation in legal activities, criminal records, and even interests of the applicant to determine whether the owner can be licensed.³⁴ Key personnel face similarly stringent requirements and a check of their police records. In the United Kingdom, the licensing authorities analyze personal details, civil litigation history, prior gaming industry and general business history, competencies, references, and prior bankruptcies to determine the ability of key personnel to be licensed.³⁵ Similarly, Panamanian authorities consider criminal records, suitable references, and general national employment regulations to determine levels of review.³⁶ From an economic perspective, these tiers can be seen as different sized barriers; high scrutiny is a substantial barrier to entry and low scrutiny is a low barrier to entry.

The most expensive and intrusive investigation is a full licensing investigation. It is a comprehensive independent review of the applicant's financial history and personal background. Full investigations are expensive because the government investigators review primary source materials. For example, rather than relying on an acquittal as a determination of innocence, government investigators may reinvestigate the incident. They will seek to learn if other evidence, perhaps that was not admissible in the criminal proceeding, might suggest guilt. In a financial context, investigators may not rely on tax returns, but instead analyze cash-flow by reviewing actual deposits and withdrawals to figure out both net worth and source of funds. These investigations are expensive and time consuming.

Partial investigation involves reviewing only limited areas on each application. Instead of a field background investigation, the regulators may conduct only a computer review of federal, state, and local police data banks. If the review does not reveal any arrests, convictions, or investigations of the applicant, the regulators may issue a license. Partial investigations provide less protection to the government. A partial investigation usually consists of a criminal history check, reviewing responses from the applicant's references, and sometimes a personal interview.³⁷ Partial investigations have two disadvantages. They may not provide enough information or personal

³⁴ Malta, *supra* note 6, at § 5(2)(i-vi)

³⁵ Gt. Brit., *supra* note 23, at §§ 128 (personal licenses are reviewed under the provisions for operational licenses), 69-70.

³⁶ Pan., Resolution No. 065 Panama, Art. 11(d) (2002), available at <http://www.mef.gob.pa/Documentos-JCJ/REGLA%20Ingles.pdf>

³⁷ Deborah L. Rhode, *Moral Character as a Professional Credential*, 94 YALE L. J. 491, 512 (1985).

contact with the applicant to provide a basis for accurate prediction of future conduct. Moreover, a cursory investigation with insufficient information verification often yields questionable information.³⁸ Nevertheless, a partial investigation provides some benefits. Most notably, it may inhibit persons with extensive criminal histories from obtaining employment in the online gaming business. Additionally, regulators may obtain useful derogatory information about applicants from third parties that may lead to denial of the application despite the absence of a negative criminal record.

Limited licenses are commonly issued to gaming employees. In such a case, the extent of the partial investigation can be tiered, with key employees being subjected to higher review than lower-level employees. Similarly, the licenses issued can place very specific restrictions on the applicant's employment activities or employment category. For example, New Jersey issues different licenses to key gaming employees, regular gaming employees, and non-gaming employees.³⁹ To differentiate types of licenses, jurisdictions may use different terminology, such as a work "permit" or "card" for the licensing of gaming and non-gaming employees.

Nevada constructed a formal tiering structure for Internet gaming service providers by identifying three classes and conducting a different level of investigation for each class.⁴⁰ Class 1 service providers are those who (a) manage, administer, or control wagers that are initiated, received, or made on an interactive gaming system; (b) manage, administer, or control the games with which wagers that are initiated, received, or made on an interactive gaming system are associated; (c) maintain or operate the software or hardware of an interactive gaming system; (d) receive payments based on earnings or profits from a game, or (e) any other applicant for a service provider license who the regulators believe should have a Class 1 license.⁴¹ Applicants for Class 1 licenses have to undergo the most stringent investigations. Class 2 services providers are any other service provider that the regulators deem as having a critical role with the gaming site's operation.⁴² These service providers have to undergo a more cursory review. Any person who is a service provider other than a Class 1 or Class 2 is a Class 3 service provider.⁴³ A Class 3 license is a probationary license more akin to a registration, and is limited to those who act as a marketing affiliate for an operator of interactive gaming.⁴⁴ Here, a "marketing affiliate" is a type of interactive gaming service provider who shares customer databases with operators, or companies that intend to license their brands to operators.

³⁸ *Id.*

³⁹ See generally Nicholas Casiello, Jr., *New Jersey*, in *INTERNATIONAL CASINO LAW*, SECOND EDITION (Cabot, *et al.*, eds., 2d ed., 1993).

⁴⁰ Nev., *supra* note 26, at § 5.240(3)

⁴¹ *Id.* at §§ 5.240(2)(d), 5.240(3)(a), 5A.020(4)

⁴² *Id.* at § 5.240(3)(b)

⁴³ *Id.* at § 5.240(3)(c)

⁴⁴ *Id.* at § 5.240(3)

To determine a level of review, placing service providers and employees in different tiers is of foremost importance. This requires consideration of three factors. First is the relationship between the group under consideration and public policy goals. For example, if the principal governmental policy is to assure the honesty of the game, the most obvious persons who need to obtain licenses are the game operators and the software suppliers or programmers. If governmental policy attempts to prevent gaming profits from going to criminals who may use them to fund criminal operations, then the licensing breadth must extend to persons sharing in profits from the games. Another example includes a government's goal to ensure that criminals have absolutely no involvement in the industry. This may mandate that suppliers of non-gaming goods and services undergo regulatory scrutiny.

Another consideration is capability and budget. Placing all groups into a mandatory licensing tier with full investigations will require a government to commit a substantial number of trained personnel to conduct the investigations or rely on third party investigations whose quality is difficult to maintain. Therefore, governments often place groups into tiers based on regulatory priority. Usually, the top priorities are owners and operators, followed by persons sharing in profits, distributors, manufacturers, and key employees. The government then assigns different levels of licensing scrutiny to each tier taking into account the budget and capacity of its investigative division.

A third consideration is the economic impact of requiring licenses for certain groups. As discussed earlier in this chapter, requiring licensure may discourage persons from applying because they are unwilling to devote the time, pay the cost, or suffer the embarrassment of the licensing process.

In sum, tiered licensing is a commonly used method for prioritizing regulatory investigation. The different tiers typically apply varying degrees of scrutiny determined by three factors: (1) the relationship between the applicant-group and public policy goals, (2) the investigative capability and budget of the regulatory body, and (3) the economic impact of licensing scrutiny.

Criteria

Gaming regulators can consider many different criteria in assessing an application for a gaming license. Criteria can be of a fixed or discretionary nature. Fixed criteria are quantifiable ones that an applicant either meets or does not. Fixed criteria can include whether person has not been convicted of a felony (South Dakota)⁴⁵ or ensuring that a person has not been convicted of any crime involving gambling, prostitution, or sale of alcohol to a minor (Mississippi).⁴⁶

⁴⁵ S.D. CODIFIED LAWS § 42-7B-33(3) (1989) (current as of 2012).

⁴⁶ MISS. CODE. ANN. § 75-76-67(3) (West 1990) (current as of 2011).

Discretionary criteria are minimum qualifications that are not subject to quantification, but are based on the discretion of the gaming regulators. For example Great Britain requires that the person is likely to act consistently with the licensing objectives.⁴⁷ The most common discretionary criteria involve good character, associations, management capabilities, and financial abilities.

1. *Good Character*

Statutes and regulations often require regulators to consider “good moral character” as a factor in screening applicants for professional and other vocational licenses involving a high degree of public trust. In Alderney, as an example, gaming commissioners will examine the applicant’s character.⁴⁸ Besides privileged licenses such as gaming, it is often a criterion in considering whether to grant a professional license, such as accounting, law, or medicine. Despite its common use, the term has limited practical utility because it is difficult to define and apply. The major problem with using “good moral character” as a criterion is the inherent subjectivity involved when judging another’s character.⁴⁹

Deciding a person’s qualification to hold a gaming license based on character functions as a total grant of discretion to the regulators. “Good” character, as opposed to “bad” character, lacks useful definition. What is good or bad is ultimately based on the individual perceptions of the person making the judgment. What is “good” or “bad” to a Baptist minister or a Bronx numbers operator will differ greatly. The former might find any applicant for a gaming license to be of “bad” character because of his choice of profession. In this context, the concepts of good and bad vary based on the political, social, religious, and psychological orientation of the regulator.

Judicial attempts to define the phrase and give concrete standards to the term “good character” are infrequent and unhelpful. One leading case that attempts to define the term is *Konigsberg v. State Bar of California*.⁵⁰ In that case, the State Bar denied an applicant admission because of “questionable moral character” based on the applicant having made certain political statements.⁵¹ The Court, discussing the definition of “good moral character” stated that:

The term, by itself, is unusually ambiguous. It can be defined in an almost unlimited number of ways for any definition will necessarily reflect the attitudes, experiences, and prejudices of the definer. Such a vague qualification, which is easily adapted to fit personal views and predilections,

⁴⁷ Gt. Brit., *supra* note 23 at § 70(2)(b).

⁴⁸ Alderney, *supra* note 9 at § 5(2)(a).

⁴⁹ Rhode, *supra* note 37 at 529.

⁵⁰ *Konigsberg v. State Bar of Cal.*, 353 U.S. 252 (1957).

⁵¹ *Id.* at 258-59.

can be a dangerous instrument for arbitrary and discriminatory denial. ...⁵²

Other courts have struggled with the same ambiguities. The Arizona Supreme Court, ten years after *Konigsberg*, conceded that “the concept of good moral character escapes definition in the abstract,” and held that each case must be judged on its own merits in an *ad hoc* determination.⁵³ Thus, the conclusion that the individual has good moral character and, therefore, is fit, is a subjective opinion only reached by comparing the individual to one’s personal concept of what is moral or immoral.

Other courts’ attempts to define “good moral character” usually resulted in defining the vague, highly subjective phrase with more vague and highly subjective phrases. For example, the North Carolina Supreme Court defined “good moral character” as:

[S]omething more than an absence of bad character. ... It means that he must have conducted himself as a man of upright character ordinarily would, should, or does. Such character expresses itself not in negatives, nor in following the line of least resistance, but quite often in the will to do the unpleasant thing if it is right, and the resolve not to do the pleasant thing if it is wrong.⁵⁴

The Arizona Court adopted, as a means of determining bad moral character, a test that inquires “whether that behavior truly portrays an inherent and fixed quality of character of an unsavory, dishonest, debased, and corrupt nature.”⁵⁵

The overall standard in this area was stated by the United States Supreme Court.⁵⁶ In that case, an applicant for admission to the Bar was rejected for questionable moral character because of his membership in the Communist Party.⁵⁷ The Court reversed, stating that:

[A] state can require high standards of qualification, such as good moral character or proficiency in its law, before it admits an applicant to the Bar, but any qualification *must have a rational connection* with the applicant’s fitness or capacity to practice law.⁵⁸

The Court found that membership in the Communist Party alone was not rationally related to one’s ability to practice law, and ordered the applicant to be admitted.⁵⁹ Applying this in a context other than the practice of law, any “good moral character” requirement would have to be rationally connected to the qualities and abilities needed to engage in that particular occupation.

A second approach that courts take in attempting to interpret “good character” is to engage in judicial interpretation of the licensing goals.

⁵² *Id.* at 262-63.

⁵³ Application of Klahr, 433 P.2d 977, 979 (Ariz. 1967).

⁵⁴ In re Farmer, 131 S.E. 661, 663 (N.C. 1926).

⁵⁵ *Klahr*, 433 P.2d at 979 (citing In re Monaghan, 126 Vt. 53, 60, 222 A.2d 665, 671 (Vt. 1966)).

⁵⁶ *Schwabe v. Bd. of Bar Exam. of State of N.M.*, 353 U.S. 232(1957).

⁵⁷ *Id.* at 238.

⁵⁸ *Id.* at 239 (emphasis added).

⁵⁹ *Id.* at 246-47.

For example, the United States Supreme Court, interpreting California decisions on bar admissions stated that the practical definition of “good moral character” tended to be stated in terms of an absence of proven acts that raise substantial doubts about the applicant’s honesty, fairness, and respect for the rights of others and for the laws of the state and nation.⁶⁰ Here, the courts determine relevancy by deciding what are good attributes for licensing in the profession being considered, and holding that good character equates to those attributes. This definition has been adopted by several other states.⁶¹ While this is a reasonable approach by courts that are faced with standard-less criteria, from a policy perspective, establishing more concrete criteria in the first instance is preferable.

Another problem with using “good character” as a criterion is attempting to define an individual as good or bad. The concept of character necessitates a review of all the person’s traits. Character, by definition, is “the pattern of behavior or personality found in an individual.”⁶²

As one commentator noted:

One problem of sorting people into two categories -- those of good moral character and those who are not -- is that most people range across the dividing line. Many, if not most, people are usually of good moral character, but not always; are frequently honest, but once in a while untrustworthy; are often loyal, but sometimes unfaithful; will be generally competent, but occasionally careless; and so on. They range along a continuum, usually acting above minimum standards, but at times falling below.⁶³

Defining “good” behavior based on a single event in a person’s life may, or may not, be justified depending on the nature of the event. If the person sold confidential government information to enemies of this country, that lone event would probably meet most people’s criteria of “bad” character. But, what about other single events? Take, for example, an applicant who had been arrested for a single instance of child abuse, agreed to counseling, and had the charges dismissed. A regulator who had been abused as a child might view this single instance as disqualifying while another might not.

Another problem with “good character” as a criterion is that regulators and investigators usually give little credence to “good” acts, but instead concentrate on trying to prove bad character. Thus, a person has “good moral character” if there are no demonstrable instances where the individual showed “bad moral character.” A definitional difficulty arises because reasonable people can differ about what conduct would raise substantial

⁶⁰ *Konigsberg*, supra note 50, at 263.

⁶¹ See, e.g., *In re Florida Bd. of Bar Examiners*, 373 So. 2d 890 (Fla. 1979); *Reese v. Bd. of Com’rs of Alabama State Bar*, 379 So. 2d 564 (Ala. 1980); BLACK’S LAW DICTIONARY 693 (6th ed. 1990).

⁶² WEBSTER’S NEW WORLD DICTIONARY 125 (Second Concise Edition (1976)).

⁶³ Banks McDowell, *The Usefulness of “Good Moral Character,”* 33 WASHBURN L. J. 323, 323 (1992).

doubts about one's moral character.⁶⁴ Defining a positive ("good moral character") through the absence of a negative ("bad moral character") is unhelpful unless there are standards provided to determine when the negative exists.

Generally, conduct evidencing "bad moral character" (in a Bar admissions context) is "[c]onduct evidencing dishonesty, disrespect for law, disregard for financial obligations, or psychological instability."⁶⁵ Conduct that is most damaging to one's character is conduct evidencing "moral turpitude," another standard open to varying interpretations.⁶⁶ Moral turpitude is an act or behavior which gravely violates moral sentiment or accepted moral standards of the community.⁶⁷ It is present in some criminal offenses, but not all.⁶⁸ Thus "moral turpitude" is similar in definition to "good moral character" and carries the same definitional inadequacies. According to one commentator, "[f]or purposes of Bar discipline, the 'moral turpitude' criteria does nothing to refine the inquiry, but merely removes it one step from its announced concern--fitness for legal practice."⁶⁹

While "good moral character" is a common criterion for licensure, it is an inherently vague bench-mark which, in reality, tends to function as a total grant of discretion to regulators. While courts have tried to narrow the definition of "good moral character," they have been largely unsuccessful. Furthermore, courts are not the ideal venue for establishing a more concrete definition because it is preferable to have a workable standard from the first instance.

2. Integrity, Honesty, and Truthfulness

Integrity, honesty, and truthfulness are three concepts that licensing statutes use as criteria to assess an applicant's suitability for a license. For example, in the Isle of Man, the commissioners will grant a license only if the company is under the control of person(s) of integrity.⁷⁰ Under Kahnawake law, besides character, the commission reviews the applicant's honesty and integrity by taking into consideration the following: personal, professional, and business associations, history of criminal convictions, history of civil litigation, credit history, bankruptcies, and personal and professional references.⁷¹

While related, these concepts of integrity, honesty, and truthfulness have different meanings. Truthfulness means simply to tell the truth. Truthfulness is only one component of honesty. One can be truthful, but

⁶⁴ Rhode, *supra* note 37, at 530..

⁶⁵ *Id.* at 532.

⁶⁶ *Id.* at 551.

⁶⁷ BLACK'S LAW DICTIONARY 1009 (6th ed. 1990).

⁶⁸ *Id.*

⁶⁹ Rhode, *supra* note 37, at 552.

⁷⁰ Isle of Man, *supra* note 19, at § 4(2)(a).

⁷¹ Kahnawake, *supra* note 21, at § 24(a)

dishonest. It is dishonest to use true facts and not disclose other facts in order to create a false impression.⁷² For example, a person who was arrested by state police can truthfully state that he was never arrested by city police. If, however, he responded to a question about his criminal record by stating he had never been arrested by the city police, it would be dishonest.

Similarly, honesty is only one component of integrity. “The word ‘integrity’... means soundness of moral principal and character, as shown by one’s dealing with others in the making and performance of contracts. . .”⁷³ A person can be honest, but lack integrity if, for example, he knowingly takes advantage of people in his business dealings.

Integrity is a complex concept that involves commitments to prioritized, personal moral principles. These principals can include honesty, family, friendship, religion, honor, country, or fairness. Persons prioritize these commitments such that it is acceptable to violate some commitments in order to honor others. For example, most people believe that it is acceptable to lie if necessary to protect another from harm or injustice.

Integrity means to upholding these commitments for the right reasons in the face of temptation or challenge.⁷⁴ For regulators to attempt to test a person’s integrity, they would have to understand the person’s personal priorities, and then decide whether the person is consistently true to these commitments and their priority. This is an impossible task in a neutral setting, but becomes even more problematic because the regulators’ sense of personal priorities might be different from the applicant’s.

Integrity might be inconsistent with regulatory policy due to the priority of the applicant’s commitments. For example, suppose the applicant values personal friendship highly. Unfortunately, he has been friends since childhood with a person who is of a notorious reputation. The regulators demand that licensees not associate with such persons; however, the applicant’s personal integrity places his personal commitment to friendship above the dictates of regulation. The applicant, to maintain his integrity, would continue to maintain his friendship. This may make him unsuitable to hold a gaming license. Therefore, regulators must be adept at defining which commitments are most important to good regulation and to testing the person’s behavior against those commitments.

Commitments that are important to meeting regulatory objectives differ between regulatory goals. Fairness and respect are more important to protecting the player than the government. Both government and player protection goals place importance on honesty. Government protection goals place greater emphasis on complying with law.

As a licensing criterion, “honesty” is generally preferable to truthfulness

⁷² *Wiggins v. Texas*, 778 S.W.2d 877, 889 (Tex. App. 1989).

⁷³ *In re Bauquier’s Estate*, 88 Cal. 302, 307, 26 P. 178 *aff’d*, 88 Cal. 302, 26 P. 532 (Cal. 1891).

⁷⁴ Lynne McFall, *Integrity*, *Ethics* 5, 9 (October 1987).

or integrity. Regulators want applicants and licensees to not only tell the truth, but to convey accurate impressions by full disclosure. Therefore, “honesty” as a criterion is preferable to truthfulness. While conceptually “integrity” appears preferable to “honesty,” it suffers because of its difficulty in application. Attempting to decide a person’s personal priorities and testing his behavior against those priorities is difficult, if not impossible.

With that being said, how useful is “honesty” as a criterion? Shakespeare wrote, in *Hamlet*, “Ay sir, to be honest, as this world goes, is to be one man picked out of ten thousand.”⁷⁵ Thomas Fuller conveyed a similar thought when he wrote, “He that resolves to deal with none but honest men must leave off dealing.”⁷⁶ The sentiments that both men convey is that no matter how committed to honesty a person may be, few, if any, people can claim to be completely honest in all their dealings.

When applying the “honesty” criterion, regulators must apply a materiality standard. An applicant is unlikely to be denied a license if he told his son that he could not take him fishing because he had to work, when, in fact, he was going to a football game. Two general rules emerge. First, that the honesty criterion generally is reviewed in a business, as opposed to a personal, context. This is justified because the purpose of licensing is to predict the behavior of the applicant as a gaming licensee. Therefore, his behavior in other business relationships is more germane to the inquiry than his personal relationships.

Second, honesty in business conduct becomes more relevant with the importance of the transaction. For example, it may be of minor materiality that an applicant, in order to cut short a telephone conversation, lied by telling the salesman that he recently bought the product being offered. The materiality increases dramatically if the applicant misrepresents the value of inventory to convince a lender to loan money to his business.

The criteria of integrity, honesty, and truthfulness all suffer from some degree of difficulty in application. Honesty, however, is an important policy goal in both the player and government protection contexts. Moreover, it is the easiest of the three for regulators to measure and judge in a meaningful way, provided the inquiry is limited to material, business-related behaviors.

3. *Competency/Management Abilities*

Operating a gaming site takes special knowledge and skills. Regulators may have concerns that otherwise honest persons might frustrate governmental goals if the operators lack the capacity to properly manage their gaming operations. For example, poor managers may not recognize when dishonest software programmers install gaff in computer programs to cheat players or steal from the site. This may frustrate a primary

⁷⁵ WILLIAM SHAKESPEARE, *HAMLET* act 2, sc.2.

⁷⁶ THOMAS FULLER, *GNOMOLOGIA* 93 (1st ed. 1732), available at <http://books.google.com/books?id=3y8JAAAAQAAJ&pg=PP1#v=onepage&q&f=false>

governmental goal by failing to ensure that games are honest. Similarly, professional cheaters and dishonest employees can more easily steal from gaming operations with poor management. This may frustrate governmental goals of collecting taxes on all revenues derived from gaming operations. Therefore, some jurisdictions, like Kahnawake, require applicants to have the appropriate services, skills, and technical knowledge to provide online services.⁷⁷

Testing for adequate management skills varies depending on the complexity of the applicant's organization and the gaming operation. The former addresses the nature of the applicant. If it is a large diverse public company, regulators generally do not expect the chairperson of the board of directors to have operational experience. Instead, the emphasis is on the management structure established for the gaming operations. Regulators often require applicants to provide organizational charts designating the persons in each position, their responsibilities, and lines of authority. These are then tested against standards of depth, *i.e.*, is there enough management coverage? Are all key management areas covered? Are responsibilities properly segregated? Does the person have adequate knowledge and experience?

The second variable is the complexity of the gaming operation. If the gaming operation is small and has only on-line electronic gaming devices that are subcontracted to a licensed hosted service provider, the requisite level of management skill is minimal and can be acquired.

In addition to management competency, regulators should investigate and consider technical competence as Internet gambling presents new challenges. While traditional gaming has become more technologically complex, Internet gambling is unique in that governments are certifying information technology which creates an internet-enabled channel in a regulated and secure environment. A gaming commission may need a devoted software architect to decide if an operator is technically competent to manage and operate an Internet gaming site, if their architecture is sound, and whether their hardware and software are well written. Relying purely on post-licensing system certification may not be sufficient if the operator has purchased or licensed the software from a third party and has no practical or technological resources to operate the site. This could be equivalent to allowing a child to drive a Porsche without a driver's license.

Incompetence can be just as destructive to a jurisdiction's policy goals as malfeasance. For this reason, regulators should scrutinize managerial competency proportionate to the complexity of the organization and gaming operation. Additionally, regulators may benefit from a dedicated software architect who can test the technical competency of applicants and their systems.

⁷⁷ Kahnawake, *supra* note 21, at § 24(b)(iii).

4. *Financial Abilities*

A government may have varying degrees of concern with the financial ability of an applicant to succeed. In a monopoly- or small oligopoly-economy, the government may have a strong interest in assuring that the prospective gaming operator is properly financed. For example, the Isle of Man requires the applicant to have adequate financial means available to conduct online gaming.⁷⁸ Similarly, Alderney's gaming commissioners review the applicant's current financial position and background. Malta is more focused on the applicant's ability to maintain the minimum required reserve.⁷⁹

In a competitive economy, the government may have fewer concerns about a new gaming operation's economic viability because there are already adequate assurances in place to protect player's funds and/or government tax revenues. Market forces in a competitive economy often are the best judge of what is viable. If this is done by the government, the market may lose a potential competitor that could succeed by introducing innovations or creating new markets. However, there may be some legitimate concerns for regulators. For example, will the operator go to some unsuitable source to get money if times get tough or will it try to create profits by cheating players? These concerns can be addressed by careful monitoring of the operator and requiring submission of periodic reports.

A closure may not hurt a competitive economy. Instead, it often helps the economy. Suppose a market can only support five gaming sites when there are six. The most marginal site has some market share. If the sixth site closes, this market share would go to the other five sites. With the sixth site open, the other five sites are less healthy because they earn less. They are also less attractive to lenders and investors. When the sixth site closes, the other sites quickly absorb their capacity and become healthier. Usually the site that fails is the one that is the least competitive because it is under financed, has an inferior product, or is overpriced.

Therefore, while the financial ability of an applicant is of some concern to regulators, it may not be necessary to make financial ability a licensing criterion. Market forces and regulatory oversight may provide sufficient protection without creating artificial barriers to entry.

5. *Compliance With Law*

An applicant's compliance with all laws applicable to its business is material to the granting of a gaming license. One function of the licensing process is to predict whether, if granted a license, the applicant will comply with all gaming laws and regulations. Strict compliance with these laws and regulations is essential to achieving the policy goals underlying them. Nothing is more predictive of future compliance with business laws and regulations than a review of past compliance in

⁷⁸ Isle of Man, *supra* note 19, at § 4(2)(d).

⁷⁹ Malta, *supra* note 6, at § 8(2)(d).

the same context. Indeed, Maltese regulators look to whether the applicant has been tainted by any illegal practices.⁸⁰

Like application of the “honesty” criterion, some instances of noncompliance may be less material than others. Less material noncompliance might include matters that do not involve dishonesty, are civil violations, involve negligence, occurred many years ago, were isolated incidences, were corrected before criminal action occurred, were self reported, or were minor compared to size of business. More material incidents of noncompliance include matters involving dishonesty, criminal violation (particularly felonies), illegal gambling, intentional or reckless acts, recent acts, repetitive acts, and acts where the applicant denied or attempted to hide violations.

Jurisdictions like the United States that are late-comers in the Internet gaming industry will be faced with a difficult decision as to whether Internet operators that have directly or indirectly (through their licensee) accepted U.S. players are ineligible for a license. No precedent exists as to whether this is or is not a disqualifying factor to obtain a license. Some jurisdictions’ laws and regulations do not have rigid criteria for determining suitability. For example, in some jurisdictions, a felony conviction or an offense involving gambling may be a disqualifying factor and pose an insurmountable hurdle for convicted applicants. Other jurisdictions follow more flexible standards. There, regulators will have to make a qualitative decision based on a totality of factors as to whether the person or company is suitable. Compliance with the law is an important aspect of that review. Compliance is much more than whether the company has violated or not violated the law, but whether it has institutional controls for assuring compliance with all laws. This is not only compliance with United States and state laws, but also with foreign laws. This ultimately might evolve into an inquiry about compliance with the laws of foreign countries, and specifically whether the company has made efforts to review and comply with the laws of all the jurisdictions where they accept wagers.

There has been much discussion about whether October 16, 2006, the date when the Unlawful Internet Gaming Enforcement Act (“UIGEA”) went into effect, should be a determining date. The thought goes that after that date, site operators knew that accepting U.S. play was unlawful. The recent California legislation proposes a December 31, 2006, date, indicating that there should be some flexibility to extend past the October 16th date.⁸¹ In reality, setting a specific date is too simplistic. For example, even if we assume that UIGEA was the first federal statute that clearly prohibited accepting U.S. play on poker or games of chance, the UIGEA date may be less relevant to those companies that accepted sports wagers. In 2001, Jay Cohen’s conviction for accepting U.S. play on

⁸⁰ *Id.* at § 8(2)(f).

⁸¹ S.B. 1463, 2012 Reg. Sess. Art. 4, § 19990.23(f)(8) (Cal. 2012) available at http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_1451-1500/sb_1463_bill_20120224_introduced.pdf

sports wagering was upheld.⁸² A question arises, therefore, as to whether 2002 is a better date for those that accepted sports wagers. In addition, these foreign operators may have additional issues with state laws such as Nevada Revised Statute 465.092 that prohibits a person who is not licensed in Nevada from accepting or receiving a wager over the Internet from a person located in Nevada. This law has been in place since 1997. Moreover, inquiry is not likely to be limited to gaming laws. Focus may shift to compliance with U.S. and state tax reporting and payment.

Prior material violation of laws is a useful licensing criterion because past compliance is a strong indicator of future compliance. Compliance with law inquiries typically include an applicant's compliance with the law of all jurisdiction in which it accepts wagers. An unsettled question in this area is how U.S. regulators should handle applications from Internet gaming operators who accepted wagers from U.S. players when doing so was a violation of U.S. law.

6. *Manner Of Doing Business*

Different people have different manners of doing business. While some are reconciliatory, and successfully resolve most disputes without the need for litigation, others are more adversarial and regularly litigate disputes. The adversarial type may create disputes to delay payment and seek favorable settlement by threatening or bringing a lawsuit. In dealing with regulators, the reconciliatory type is cooperative, and agrees on appropriate behavior. The adversarial type challenges the authority of the regulators and ties up regulatory resources in court challenges.

Reconciliatory types make better gaming licensees. They are more willing to conform their behavior to the expectations of the regulators. By not challenging the regulatory authority through litigation, regulatory costs are reduced. On the other hand, adversarial types may provide an important check on regulators. If no licensee challenges regulatory actions that exceed the regulator's authority or that are inconsistent with legislative policy, public policy goals might be frustrated without the knowledge of either the legislature or the chief executive. In addition, citizens in most societies have the right to seek judicial redress of grievances. Prejudicing an applicant for exercising legal rights would appear unjust.

In any circumstance, where an applicant abuses the legal system, regulators may justifiably consider this in assessing suitability for a license.

7. *Criminal History and Prior Convictions*

Several jurisdictions that regulate online gaming, including Malta, Kahnawake United Kingdom, and Panama, investigate the applicants' criminal history, background, or records.⁸³ Given that regulators must

⁸² See *United States v. Cohen*, 260 F.3d 68, 78 (2d Cir. 2001).

⁸³ Malta, *supra* note 6, at § 5(2); Kahnawake, *supra* note 21, at § 24(a) (investigating con-

necessarily focus on past actions to determine moral character, especially past criminal actions, what type of history should disqualify someone from obtaining a license? A jurisdiction may take two approaches. First, the jurisdiction may use a fixed criterion system which holds that anyone convicted of a felony, a crime involving gambling, or a crime involving “moral turpitude” is ineligible for a gaming license. A second approach would be to allow the introduction of a criminal conviction as evidence of the person’s unsuitability, but still consider other evidence to decide overall suitability. Under this view, a criminal conviction creates a presumption of unsuitability and shifts the burden on the applicant to rebut that presumption by showing rehabilitation.⁸⁴ In the case of *In re Application of Cason*, the Georgia Supreme Court stated that this rebuttal must be by clear and convincing evidence.⁸⁵ The Court went on to state that for Bar fitness purposes, the applicant must reestablish his or her reputation by showing a return to a “useful and constructive place in society.”⁸⁶ This cannot be evidenced by merely paying a fine or serving time, but must be evidenced by affirmative action, such as community service, occupation, or religion.⁸⁷ This “test” allows licensing committees considerable leeway in determining eligibility based upon their own subjective attitudes. Still, it does little to establish that a person who has committed crimes in the past will not commit them again in the future.

Under the discretionary approach, no definitive tests are available to decide whether a person with a history of criminal activities can earn a gaming license. In some instances, convicted criminals may receive gaming licenses. Similarly, the gaming authorities may deny licenses to persons never convicted of a crime, but who failed to show a lack of involvement in criminal activities. Gaming regulators may consider several facts in assessing whether to deny an application based on prior criminal activities. These include:

- The nature of the crime; criminal activities involving moral turpitude, such as thievery or embezzlement, are very significant;
- Mitigating or extenuating circumstances;
- Proximity in time of the criminal activity;
- Age at time of the criminal activity;
- A pattern or high frequency of criminal activity; and
- The applicant’s honesty and forthrightness in revealing the past criminal activity to gaming investigators.

Some past crimes committed by an applicant may have no relation to their ability in some particular occupations. For example, a person

victions only); Gt. Brit., *supra* note 23, at § 71; Pan., *supra* note 36, at Art. 11(d).

⁸⁴ Maureen M. Carr, *The Effect of Prior Criminal Conduct on the Admission to Practice Law: The Move to More Flexible Admission Standards*, 8 GEO. J. LEGAL ETHICS, 367, 383 (1995).

⁸⁵ *In re Cason*, 294 S.E.2d at 522.

⁸⁶ *Id.*

⁸⁷ *Id.*

convicted of child molestation 15 years ago is probably unfit to be licensed to operate a child care center, but it does not follow that the same person is not “morally” suitable to operate a gaming operation. There is no rational connection between the two, and the fact that the person was convicted of child molestation in the past provides a poor basis for predicting that the person is morally incapable of operating a fair gaming operation.

Predicting the morality of future behavior using an applicant’s criminal history may be an imperfect assessment, but it is perhaps some of the strongest predictive evidence available to regulators. A fixed criteria approach is an easy standard to implement, but may not be a strong predictive tool, especially when the applicant’s criminal history and license obligations do not correlate. A nuanced discretionary approach can address some of the shortcomings of the fixed criteria test by looking to the circumstances surrounding an applicant’s criminal history and the applicant’s subsequent conduct.

8. *Associations With Unsuitable Persons*

If gaming licensees have friends with notorious backgrounds, the public may believe that the unsuitable persons have an interest in, or influence over, the gaming operations. A person’s willingness to associate with disreputable people may also call into question his own character.

The problem with the concept of association is definitional. One court noted “the word ‘associate’ is not of uniform meaning but is, rather, vague in its connotation.”⁸⁸ For example, do incidental contacts with known criminals constitute association? What about involuntary contacts? What if the applicant had no knowledge of the other person’s unsuitability?

Some courts define association as more than incidental contact with unsuitable persons. In interpreting a regulation prohibiting police officers from “associating” with criminals, one court held that the term means more than “incidental contacts” between police officers and known criminals.⁸⁹ The issue in another case was whether a parolee violated his parole by “associating” with undesirable persons.⁹⁰ There the court defined association as “to join often, in a close relationship as a partner, fellow worker, colleague, friend, companion, or ally.”⁹¹

While difficult to define, the concept of unsuitable “associations,” should focus on the following:

- Nature and intensity of the relationship. Facts considered include: (1) type of relationship; *i.e.*, business or friendship; (2) knowledge of the second person’s unsuitability; (3) whether the relationship was voluntary; (4) frequency or involvement of the relationship;

⁸⁸ *Weir v. United States*, 92 F.2d 634, 638 (7th Cir. 1937), *cert. denied*, 302 U.S. 761, 58 S. Ct. 368, 82 L. Ed. 590 (1937).

⁸⁹ *Sponick v. City of Detroit Police Dept.*, 49 Mich. App. 162, 211 N.W.2d 674 (1973).

⁹⁰ *State v. Morales*, 137 Ariz. 67, 668 P.2d 910 (Ariz. Ct. App. 1983).

⁹¹ *Id.* at 68.

and (5) the applicant's attitude after becoming aware of the concern by gaming authorities with the relationship;

- The influence or control over the applicant by the other person;
- The nature of the concern about the second person and how that concern poses a threat to the public interest; and
- The number of questionable relationships.

An inquiry based on these factors is more likely to avoid the injustices of a simple "guilt by association" approach while preserving regulators' ability to exclude persons who are truly unsuitable due to their associations.

9. *Conduct During the Investigation*

Statutes or regulations generally require applicants to make full and true disclosure of all information requested by the regulatory agents during the investigation.⁹²

The applicant's conduct during the investigation may become relevant to his suitability for many reasons. If the applicant attempts to hide or mischaracterize a past transgression, the regulators may question the applicant's current credibility. If the applicant is not cooperative, the regulators may question whether the applicant will adopt such an attitude when it comes to compliance with the controls. If the applicant keeps disorganized and incomplete financial and personal records, the regulators may question the applicant's ability to account properly for taxes.

Standards of Proof

In licensing matters, the burden of proof is usually on the applicant. This is logical because the applicant has the most direct access to the information regulators may use to decide his suitability. If the applicant cannot produce this evidence, then it probably does not exist. Similarly, the burden of persuading the regulators of the applicant's suitability should be on the applicant.

A party that has the burden of proof must, at a minimum, present evidence to support the requested decision. For example, if an applicant has the burden of proving his suitability, then the applicant must provide at least enough evidence to allow the regulators to decide whether the applicant is suitable. In matters such as licensing, the burden of proof may also insinuate the burden to persuade the regulators of the applicant's suitability.

The agency decides factual matters by weighing the evidence and making a decision. But, not all decisions are made by stacking evidence on different sides of the scale and choosing the side with the most substantial evidence. Decision-makers have different ways to "weigh" evidence. Perhaps the most commonly recognized standards are "beyond a reasonable doubt," and "a

⁹² See, e.g., NEV. REV. STAT. §463.339.

preponderance of evidence.” The former emanates from the standard used in criminal trials; the amount of evidence supporting a particular decision should be sufficiently substantial so as to eliminate any reasonable doubt that a contrary conclusion could be reached.

The common standard for a civil trial is a preponderance of the evidence. This is the “scale of justice” test. It requires the decision-maker to look at the evidence and decide which of different conclusions is more likely to be true. Suppose, for example, a dispute arises over whether the player placed a wager on a roulette table before or after the dealer called for no further bets. The decision-maker may hear contradictory testimony from many persons, including the player and the dealer. The decision-maker must then decide which was more likely to have occurred. Having a conclusion, the decision-maker would then apply the relevant law.

Another standard is “clear and convincing evidence.” This standard calls for the party with the burden of proof to provide “clear and convincing evidence” to support the requested decision. This standard is higher than a preponderance of the evidence, but less than beyond a reasonable doubt.

An even higher burden than “beyond a reasonable doubt” would be to prove a matter “beyond any doubt.” If an applicant for a gaming license must prove his suitability “beyond any doubt,” he has a substantial burden. If the investigation revealed any evidence that raised any doubt as to his suitability, then the agency should deny the application. For example, suppose the applicant was convicted of shoplifting while a college student, but had no other criminal transgressions. This instance alone might create doubt as to his suitability, but may not rise to the level of reasonable doubt.

The highest burden is when the applicant must prove no evidence exists that he is unsuitable to hold a license. This is an unrealistic standard because virtually every person has some incidences in the course of a lifetime that would provide negative evidence. In most cases, however, they are minor and should not disqualify the person from holding a license.

Given discretion to either grant or deny a license, regulators must assess the evidence in a given application against some standard. This can be pre-defined or left to the intuition of the regulators. For example, the regulators may be given a statutory directive to deny an application if the regulators have any reason to believe that the person does not qualify. This standard would result in fewer licenses being approved compared to a standard that would require the regulators to grant a license based on a preponderance of the evidence. For example, suppose a person was convicted twenty years ago of theft, and a licensing criterion is honesty. Obviously, theft involves dishonesty. Therefore, the theft is evidence of the person’s lack of honesty. If regulators are compelled to deny a license when any evidence exists to suggest that the applicant does not qualify, the person would be denied a

license. Suppose, further, that the person has led an exemplary life since that conviction for taking the cement sleeping bear mascot from a motel's lawn as a college prank. Under the preponderance standard, he would probably obtain a license.

Standards of proof can vary depending on the state's public policy. Under both the player and government protection goals, the government has a strong interest in assuring that unsuitable persons are not involved in the gaming industry. In these circumstances, the standard of proof should exceed that of a preponderance of the evidence. The level to which this standard rises depends on the intensity of government's policy. If the government insists on and enforces a "clear and convincing" standard, it will have a high efficiency rate, *i.e.* it will likely succeed in keeping out nearly all criminal elements. It also will create a moderate barrier to entry. As the government increases the level of the standard of proof, the less likely it is that criminal elements will infiltrate the gaming industry, but the barriers to entry will also increase.