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Time to Fold the Unlawful Internet Gambling Enforcement Act A Bad Law with Perverse Outcomes

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Hoping to be seen to be “doing something” about the perceived problem of Internet gambling, Congress approved the Unlawful Internet Gambling Enforcement Act (UIGEA) in October of 2006.¹ The Act, however, seems unlikely to stop Internet gambling and could even threaten the stable, smooth operation of America’s banking system. UIGEA and its currently proposed enabling regulations will undermine the financial privacy of all Americans and reduce the security of their bank accounts. In short, UIGEA makes almost no financial, social, or economic sense. It deserves reexamination.

To that end, this paper’s first section gives an overview of UIGEA’s provisions and the regulations proposed to implement them, the second describes the law’s likely and perverse consequences, and its conclusion outlines some principles for reforming or eliminating this harmful law.

About UIGEA and its Implementing Regulations. Congress enacted UIGEA into law as part of a port security measure. The law’s title suggests that it deals with gambling. But UIGEA, at its root, serves to regulate banking and credit cards. It has nothing to do with port security and, just as importantly, *does not actually ban any type of Internet gambling activity that was not already illegal under state laws.*

Instead, the law focuses on electronic financial transactions potentially linked to Internet gambling. Its core provision, section 5363, forbids people “engaged in the business of betting or wagering” from “knowingly” accepting “in connection with the participation of another person, in unlawful Internet gambling” any automated clearing house transaction, or bank draft. The law, furthermore, offers an amorphous description of “wagers” as any effort to stake:

something of value upon the outcome of a contest of others, a sporting event, or a game subject to chance, upon an agreement or understanding that the person or another person will receive something of value in the event of a certain outcome.²

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Thus, the law touches every sort of financial service provider: banks, credit unions, credit card companies, wire transfer services, and even brokerages. It exempts insurance, stock and commodity trades, fantasy sports leagues, horse racing, and all activities permitted under state and tribal law.

Regulations proposed to implement UIGEA impose an affirmative obligation on banks, credit unions, and credit card companies to block improper gambling transactions.³ In its justification for the proposed implementing regulations, the U.S. Department of the Treasury—designated as chief regulator under UIGEA—acknowledges that a burden exists on financial transaction providers “participating in each designated payment system, to establish policies and procedures reasonably designed to identify and block or otherwise prevent or prohibit restricted transactions.”⁴

In the regulation itself, the Treasury Department requires all U.S. financial institutions to “otherwise prevent or prohibit the acceptance of the products or services of the designated payment system or participant in connection with restricted [that is, gambling-related] transactions.”⁵ The Treasury rulemaking notice makes clear that the burden will rest with financial services providers rather than with any governmental entity.

Moreover, although the rulemaking notice considers creating a list of banned gaming providers, the proposed rule does not do so and the rulemaking notice simply solicits comments on the costs and potential benefits of creating such a list.⁶ In other words, the Treasury considered a narrower exemption but, instead, decided to leave the regulation vague and amorphous.

Likely Consequences. Upon close examination, the UIGEA and its implementing regulations appear vague, misleading, and likely to have enormous—perhaps destructive—consequences for America’s banking system. They would impose costs likely to be passed on to consumers, could have major unanticipated consequences on non-gambling financial transactions, and result in wholesale invasions of privacy.

Nobody doubts that UIGEA will cost a lot of money to enforce. The Treasury Department’s official rulemaking notice anticipates that simply correlating and recording the information required under UIGEA will cost \$20 million and require 350,000 person-hours a year⁷—the equivalent of hiring over 330 new full-time government bureaucrats.⁸ Every bank, credit union, wire transfer service, and credit card provider will need to develop new procedures, and these will cost money. The Small Business Administration’s Office of Advocacy has expressed concerns that the cost estimates attached to the law and its impact on small business seem excluded from the analysis.⁹

It is very likely that consumers will pay all of the enforcement costs directly. All regulations and taxes have costs which somebody must pay, and consumers are not always the ones paying. For example, competitive pressures can incentivize a retailer to first pass rising costs on to its employees, stockholders, or suppliers. It cannot immediately pass the costs on to consumers because it does not regularly bill—much less pay—them. This is not so in the banking sector, because banks have ongoing relationships with all of their account holders and borrowers—they pay interest, charge fees, and set interest rates on an ongoing basis. This makes it relatively easy for banks to pass on regulatory and tax costs directly to their customers.¹⁰ In the case of the

regulatory burden imposed by UIGEA, there is no reason to doubt that they will do so. UIGEA will very likely result in higher loan rates, lower savings and CD interest rates, and higher fees for consumers who are in no way involved in Internet gambling.

Just as importantly, UIGEA's statutory vagueness—which the proposed regulations do not address—could create confusion that would threaten nearly *any* type of financial transaction. The Act's definition of unlawful gambling, discussed above, proves terribly vague upon analysis. There is a strong case—advanced by the Poker Players Alliance chairman, former U.S. Senator Alfonse D'Amato—that poker and similarly skilled games like blackjack, bridge, and chess do not fall under the law's definition of gambling since long-term performance does not depend on chance.¹¹ Indeed, since poker and other similar games are clearly legal under some state laws, any attempt to enforce the law nationally would raise significant federalism questions.¹² Even if it were possible to establish an enforcement regime that theoretically satisfied all concerns about different state laws, most banks can offer their services to people living in any state, so enforcement would prove very difficult if not impossible.

Furthermore, the list of chancy activities exempted from UIGEA contains several large holes and potentially problematic provisions. The law, as currently written, bans “staking or risking...something of value...upon an agreement or understanding that the person or another person will receive something of value in the event of a certain outcome”¹³ while specifically exempting investments in securities, commodities, over-the-counter derivatives, and insurance.¹⁴ Hedge funds and offshore reinsurance contracts do not fit neatly into any of these categories, so UIGEA could conceivably restrict those activities at the same time that it restricts gambling.

Transactions involving eBay (and other online auction providers) face a similar potential problem. Specifically, “mystery auctions,” which are quite common on eBay, could be found illegal under the law since their cost and value, as in games of chance, depends on the number of participants, and the outcome is uncertain.¹⁵ Unless eBay itself were to move to stop these “mystery auctions,” all transactions coming from PayPal, BidPay, or any other processor of eBay payments would immediately become suspect of involvement in “unlawful” transactions (since state law may technically forbid them as well) and thus subject to blocking. On the other hand, no one has suggested that banks have an affirmative obligation to block offline gambling proceeds, even those from illegal gambling.

Thus, the law's likely consequences appear particularly perverse: People who win money in existing offline illegal bookmaking could continue to deposit their earnings in a bank without any repercussions so long as they pay federal taxes (as they can today), while transactions on eBay and involving hedge funds and reinsurance become immediately suspect, and perhaps impossible to carry out, under UIGEA.

These two examples illustrate just two possible problems with the law: Others will probably discover other potential inconsistencies, loopholes, and flaws. Confusion will result. Banks, credit card issuers, credit unions, and other financial institutions simply will not have a good way of knowing which transactions the Act allows and which it prohibits.

All of this uncertainty could present a huge threat to privacy. Numerous existing banking regulations require banks to obstruct transactions that may involve terrorism or drug dealing. These regulations describe the particular things prohibited and outline particular “safe harbor”

reporting provisions.¹⁶ The UIGEA offers none of these assurances. The law and its proposed implementing regulations simply mandate the blocking of certain types of gambling transactions without specifying the nature of those transactions or providing much guidance as to how banks can identify them.

Given the size and sophistication of the U.S. banking system, there is little doubt that reasonably workable solutions to these problems could eventually come to light. On the other hand, confusion over transactions will likely sap confidence in financial institutions, and thereby hurt consumers.

Alternatives to UIGEA. Potential alternatives to the deeply flawed UIGEA include three options: (1) a direct ban on all or nearly all Internet gambling, (2) federal regulation of Internet gaming, and (3) repeal of UIGEA.

1. A Direct Ban on Internet Gambling. Initial proposals to regulate Internet gambling envisioned expanded wire fraud laws that would serve to ban nearly all Internet gambling.¹⁷ This approach would make it illegal for Internet service providers to do anything that would facilitate online gambling even where state law otherwise authorized it. It would essentially ditch the vague and unenforceable banking regulations envisioned under UIGEA and replace them with a clear ban on online gambling. This would do more to limit online gambling than UIGEA.

However, this approach would trample states' prerogatives to legalize and regulate gambling—something that all states have done to varying degrees—and will likely prove unenforceable.

To begin with, outlawing all online gaming is extreme and anachronistic today. After all, most states have decided to legalize gambling on a large scale. In 1978, only one state allowed table games, casino poker, and slot machines. Today, all but 12 allow at least one of these activities.¹⁸ Forty-two states and the District of Columbia operate lotteries. Other states allow bingo, pull-tab machines, and other forms of gambling. In all, 48 states—all but Utah and Hawaii—have some form of legal outside-the-home gambling. (Although a few archaic laws may remain on the books, no state enforces laws banning friendly, not-for-profit games at home.) America has had a debate over gambling and the pro-gambling side has won. Today, the relevant public policy debate involves the extent, regulation, and taxation of gambling, not its fundamental legality. A total prohibition makes little sense in the modern social context.

In any case, a prohibition will likely prove impossible to enforce. The nature of the Internet makes it almost impossible to place anything beyond everybody's reach. For example, illegal, fraudulent pyramid-scheme scams flourish online.¹⁹ Gambling is both legal and more popular than pyramid schemes, so it is highly unlikely that any government action could effectively squash online gambling even if it were directly outlawed.

2. Federal Regulation of Internet Gambling. Several members of Congress have proposed legislation to leave some or all of UIGEA in place while simultaneously legalizing and taxing some types of online games played for money.²⁰ One bill, H.R. 2610, sponsored by Rep. Robert Wexler (D-Fla.), would amend UIGEA to remove its applicability to "skill games" like "poker, chess, bridge, and mahjong or any other game where success is predominantly determined by a player's skill" and where there is no "house."²¹ Although it does not resolve UIGEA's massive underlying problems, this law sets some clear boundaries between games of chance like online

slots, roulette, baccarat, and even mystery auctions, which would remain subject to UIGEA's strictures (and illegal except where allowed under state law), and "skill games" like poker, which would be clearly legal and regulated. The federal government would also collect "appropriate" taxes, implement regulations to stop minors from playing these games online, and develop efforts to help problem gamblers.²²

While far from optimal, this bill would represent an improvement over the status quo for at least two reasons. First, it clarifies some things that the law never should have drawn into doubt in the first place. Although one of them—poker—has become a feature of many casinos, skill games are not gambling as most people think of it. In all but the shortest games, an unskilled player will lose at roughly the same rate that a typical recreational golfer would lose matches against Tiger Woods—that is to say, 100 percent of the time.

Second, it will almost certainly require less administrative overhead than UIGEA. It is difficult or impossible to run a successful scam involving a game of skill: A website where players lose more often than they would in the real world will not attract customers in the long run. Besides mandating age verification—something all responsible gambling sites already do—a light regulatory hand would probably serve the regime very well.

The other two proposals, the Internet Gambling Regulation and Tax Enforcement Act (H.R. 2607), sponsored by Rep. Jim McDermott (D-Wash.) and the Internet Gambling Regulation and Enforcement Act (H.R. 2046), sponsored by Rep. Barney Frank (D-Mass.), offer more specific tax, licensing, and regulatory schemes for online gambling in general, not only skill games. The relative merits and liabilities of these two regulatory schemes lie beyond the scope of this paper, but both would, at least, fix the manifest problems of UIGEA and the chaos it could easily create in the U.S. banking system.

It may eventually emerge that no regulatory scheme involving the U.S. government proves effective. Given the intrinsically international nature of the Internet, any national regulator—no matter how well run—would be easy to evade. In the end, gamblers and governments alike may find that it makes more sense to place online gambling under a newly created private authority or group of authorities. Major international accounting firms and new, single-purpose international gaming regulators seem particularly suited to this task.

3. *Repeal of UIGEA.* Even before it considers proposals for the regulation of online gambling, Congress should consider an outright repeal of the Unlawful Internet Gambling Enforcement Act. The law has very little to do with gambling and serves as a poorly thought-out banking regulation fraught with potentially perverse incentives. Quite simply, it is a bad law. Repealing it makes sense. At the same time, Congress should strongly consider member proposals to perform comprehensive research related to the nature of Internet gambling.²³ This would give online casino operators, banking institutions, states, players, and other consumers time to create a workable and productive group of institutions for regulating Internet gambling.

Notes

¹ 31 U.S.C. § 5361–5367

² § 5362(1)(A).

³ Docket Number Treas-DO-2007-0015.

⁴ *Ibid.*

⁵ Ibid, 30 and 5(b)(1)(i), 43.

⁶ Ibid, 23-25.

⁷ Ibid, 33.

⁸ Authors' calculation based upon 2,000-hour work-year.

⁹ Thomas M. Sullivan and Jennifer A. Smith, "Re: Prohibition on Funding of Unlawful Internet Gambling Act [sic] of 2006," Small Business Administration, Office of Advocacy, http://www.sba.gov/advo/laws/comments/frs07_1212.html.

¹⁰ For a general overview of the literature of business taxation see William M. Gentry, "A Review of the Evidence on the Incidence of the Corporate Income Tax," United States Department of the Treasury, Office of Tax Analysis, Paper 101, December 2007, <http://www.treas.gov/offices/tax-policy/library/ota101.pdf>.

¹¹ Alfonse D'Amato, Letter to the Department of Treasury Office of Critical Infrastructure Protection and Compliance Policy, December 12, 2007, The Poker Players Alliance.

¹² Ibid, 3.

¹³ 31 U.S.C. 5362 (1)(A)

¹⁴ 31 USC 5372 (1)(E)(i-iv) [various types of investments] and (v) [insurance]

¹⁵ A mystery auction involves a "mystery box" or, sometimes, an auction that includes a dozen "envelopes" one of which contains something far more valuable than the minimum bid price. At 5:50 ET on March 8, 2008, eBay.com listed 849 such auctions. Item 300205287742 was typical: It involved \$29.99 starting bids for 10 envelopes, nine of which contained "a gift from [the seller] to [the buyer]" and one of which contained an Apple iPhone.

¹⁶ 31 USC 53 5313 (a), for example, requires the Secretary of the Treasury to establish regulations for reporting particular kinds of banking system transactions. Currently, all transactions \$10,000 and over must be reported. Other laws limit the use of the banking system by designated state supporters of terrorism, terrorist organizations themselves, and organized crime.

¹⁷ e.g. H.R. 4777 (2006), "The Internet Gambling Prohibition Act"

¹⁸ American Gaming Association, "Industry Information: Fact Sheets: General Info: States with Gaming," http://www.americangaming.org/Industry/factsheets/general_info_detail.cfv?id=15.

¹⁹ See e.g. HYIPinvestment, www.hyipinvestment.com. Because they use the proceeds from new investors to pay off old ones, pyramid schemes will always defraud more people than they reward and are thus fraudulent by definition.

²⁰ H.R. 2610, , H.R. 2607, H.R. 2046.

²¹ H.R. 2610 (3)(f). Twenty-one, although not casino blackjack, would also presumably be legal under this law.

²² H.R. 2610 (2)(6)(A). Presumably, this would mean income taxes on winnings, which are assessed on all offline gambling.

²³ H.R. 2140.