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Internet Gambling

AN OVERVIEW OF THE ISSUES

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Report to Congressional Requesters
United States General Accounting Office

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INTERNET GAMBLING
An Overview of the Issues

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The Honorable Michael G. Oxley
Chairman
Committee on Financial Services

Internet gambling is a growing industry. Since the mid-1990s, Internet gambling operators have established approximately 1,800 e-gaming Web sites in locations outside the United States, and global revenues from Internet gaming in 2003 are projected to be \$5.0 billion dollars. In 1996, Congress created the National Gambling Impact Study Commission to examine the social and economic impacts of gambling, including Internet gambling, by conducting a comprehensive legal and factual study. In its 1999 report, the commission recommended (1) that the federal government prohibit any Internet gambling not already authorized and encourage foreign governments not to harbor Internet gambling organizations, and (2) that Congress pass legislation prohibiting the collection of credit card debt for Internet gambling.² The social and economic concerns about Internet gambling raised in the report included underage gambling, pathological gambling, lack of consumer protections, and criminal abuse. In response to these concerns, numerous bills were introduced in Congress to prohibit Internet gambling.

To assist with your continuing deliberations on Internet gambling, you asked that we review the use of the U.S. payments system, particularly credit cards, to restrict illegal Internet gambling. Specifically, our objectives were to:

- examine the legal framework for Internet gambling activities, primarily in the United States, but also in selected foreign countries;
- describe the nature and scope of the policies and procedures the credit card industry has implemented to restrict the use of credit cards as a form of payment for Internet gambling; and
- obtain views on the vulnerability of Internet gambling to money laundering.

We issued an interim report on these issues in September 2002 and are now issuing our final report.³ It includes additional information on the policies of selected foreign jurisdictions, on regulations governing horse racing, on the policies and procedures of U.S.-based credit card banks and third-party processors, and on alternative payment mechanisms.

To address the legal issues in the United States, we researched federal and state laws, reviewed judicial opinions, and examined related studies. We also spoke with representatives of the Department of Justice (DOJ) and the offices of the attorneys general for selected states. For the international legal framework, we contacted gaming and government officials and gaming lawyers in selected countries and researched secondary sources that describe their laws. To obtain information on the credit card industry's efforts to deal with Internet gambling, we interviewed officials of the four major credit card organizations, some large issuing and acquiring member banks, several third-party processors, and a number of banking trade associations. We conducted an electronic survey of 202 Internet gambling sites, which is a representative sample of the approximately 1,800 Internet gambling sites. We used the survey to gather information on, among other things, payment acceptance policies for Internet gambling Web sites. We also interviewed gaming industry experts, state representatives, and law enforcement officials to obtain their views on the susceptibility of Internet gambling to money laundering and on some of the legal issues pertaining to on-line gaming. Appendix I discusses our scope and methodology in detail.

Internet gambling is an essentially borderless activity that poses regulatory and enforcement challenges. The legal framework for regulating it in the United States and overseas is complex. U.S. law as it applies to Internet gambling involves both state and federal statutes. In general, gambling is regulated at the state level, with each state determining whether individuals can gamble within its borders and whether gaming businesses can legally operate there. Five states (Illinois, Louisiana, Nevada, Oregon, and South Dakota) have enacted laws that specifically prohibit certain aspects of Internet gambling, but laws in other states that prohibit some types of gambling activities generally apply to Internet gaming as well.

Federal law recognizes that state laws vary and seeks to ensure that neither interstate nor foreign commerce is used to circumvent them. To date, 18 U.S.C. § 1084 (commonly referred to as the Wire Act) is the principal federal statute that has been used to prosecute Internet gambling activities across state lines.⁴ Although other acts appear to have direct applicability to on-line gambling, we are unaware of federal prosecutions under these statutes.⁵ However, these other federal statutes have been used to prosecute gambling establishments (often located offshore) that accept bets over the telephone. According to an interactive gaming industry services group, Internet gambling has been legalized in over 50 countries and jurisdictions, mostly in Europe, the Caribbean, and the Australia/Pacific region.⁶ A few countries and jurisdictions have prohibited it, but we were unable to determine the exact number.

Many major credit card industry participants have attempted to restrict the use of credit cards for Internet gambling but have faced challenges in their efforts to do so. Full-service credit card companies that issue their own cards and license merchants

to accept cards have implemented policies prohibiting customers from using their cards to pay for Internet gambling transactions and will not license Internet gambling sites. Credit card associations⁷ have instituted a different approach--a transaction coding system that enables association members, at their discretion, to deny authorization of properly coded Internet gambling transactions. Many major U.S. issuing banks that are members of these associations have chosen to block such transactions because of concerns over Internet gambling's unclear legal status and the high level of credit risk associated with the industry. These efforts are hampered, however, by Internet gambling sites that attempt to disguise their transactions to keep from being blocked by the issuing banks. In addition, some association members--primarily those in foreign jurisdictions where Internet gambling may be legal--continue to acquire Internet gambling sites as merchants. Further, efforts to restrict the use of credit cards for Internet gambling can be circumvented by cardholders' use of on-line payment providers to pay for gambling activities.⁸ With such intermediaries, issuing banks cannot necessarily determine the nature of the activity being charged. In spite of these challenges, the credit card industry's efforts to restrict the use of credit cards for Internet gambling could, according to research conducted by gaming analysts, reduce the projected growth of the Internet gaming industry in 2003 from 43 to 20 percent, reducing industrywide revenues from a projected \$5.0 billion to approximately \$4.2 billion.⁹ However, as banks increasingly choose to restrict the use of credit cards for Internet gaming, Internet gambling sites are expected to emphasize newer forms of payment, such as e-cash, that could eventually replace credit cards. ¹⁰

Representatives of law enforcement agencies, regulatory bodies, and the credit card and gaming industries expressed mixed views regarding the vulnerability of Internet gambling to money laundering. Law enforcement officials said they believed that Internet gambling could potentially be a powerful vehicle for laundering criminal proceeds at the relatively obscure ..layering.. stage of money laundering.¹¹ They cited several characteristics of Internet gambling that they believed made it vulnerable to money laundering, including the volume, speed, and international reach of Internet transactions and the offshore locations of Internet gambling sites.

In their view, these characteristics promoted a high level of anonymity and gave rise to complex jurisdictional issues. Law enforcement officials acknowledged the lack of adjudicated cases involving money laundering through Internet gambling sites but cited what they believed to be contributing factors, including the lack of any industry regulations or oversight. Banking and gaming regulatory officials did not view Internet gambling as being particularly susceptible to money laundering, especially when credit cards, which create a transaction record and are subject to relatively low transaction limits, are used for payment. Likewise, credit card and gaming industry officials did not believe Internet gambling posed any particular risks in terms of money laundering. Gaming industry officials did not believe that Internet gambling was any more or less susceptible to money laundering than other types of electronic commerce and pointed out that, in their view, the financial industry, which is responsible for the payments system, is better suited to monitoring for suspicious activity in the area than the gaming industry itself.

This report makes no recommendations. We provided copies of this report to the Departments of Justice and the Treasury for their comment. DOJ had no comments on it. Treasury provided technical comments, which we incorporated where appropriate.

Before the 1990s, individuals who wanted to place a casino- or sports-type bet in the United States basically had two choices: they could travel to a legitimate brick-and-mortar gaming establishment or place an illegal wager through a bookmaker. However, with the emergence of the Internet in the mid-1990s, a new form of gambling appeared--on-line gaming casinos and sports wagering. Internet gambling can take place on any electronic device that offers Internet access anywhere on the globe. In 2001, some gaming analysts were projecting that gross revenues from Internet gambling would exceed \$6 billion by 2003. However, analysts lowered revenue estimates for a number of reasons, including increased pressure from U.S. lawmakers and the blocking of Internet gambling transactions by many large U.S. credit card issuers. (U.S. customers are reported to constitute anywhere from 50 to 70 percent of total operator revenues from Internet gambling.) And, despite the recent revenue reduction, the e-gaming industry continues to grow. In a recent report,¹² gaming analysts estimate that in 2003 revenues from Internet gambling industrywide will be \$5.0 billion,¹³ or approximately 4.3 percent of the total \$116 billion in business-to-consumer global e-commerce.¹⁴ In the view of gaming analysts, the international markets (non-U.S. customers) represent the future of the industry's growth.

On-line payment providers (also known as payment aggregators): These companies send and receive funds electronically for such uses as on-line auctions and purchases.

Wire transfers: Some gaming Web sites promote this method of payment, which allows Internet gaming customers to wire money directly from a bank account to a gaming Web site. In some instances, bank wire information is posted on individual gaming sites, and gaming operators frequently use wire transfers to pay customers.

..E-cash.. or digital cash: This method of payment is a digital representation of real money that can be placed on a computer hard drive, smart card,¹⁶ other devices with memory, (including cellular phones and other electronic communication devices), or in an on-line repository. Consumers purchase e-cash from an authorized provider. These funds can then be transferred among vendors and individuals using compatible electronic systems, in some cases without resorting to banks or other financial intermediaries. When customers spend the e-cash, it is credited to the retailer's e-cash account and later transferred to the retailer's regular bank account.

Internet gambling sites also offer money orders; traveler's checks; bank drafts; cashier's, certified, and personal checks; and a number of other electronic banking systems or processors as payment options.

The House of Representatives recently passed the Leach-LaFalce Internet Gambling Enforcement Act (H.R. 556) to further limit opportunities for gambling over the Internet in the United States. H.R. 556, which passed a House vote on October 1, 2002, has been referred to the Senate Committee on the Judiciary. If H.R. 556 is enacted, it will prohibit any person engaged in the business of gambling from knowingly accepting bank instruments

such as credit cards, electronic fund transfers, or checks for illegal Internet gambling. Additionally, the Comprehensive Internet Gambling Prohibition Act of 2002 (S. 3006), introduced in the Senate in late September 2002, would, if enacted, amend certain sections of the Wire Act to include the use of all interstate or international communication facilities transmitting to or from the United States and expand the prohibited gambling activities covered by the act. H.R. 5760, introduced in November 2002, represents a different approach. If enacted, it would establish a commission to conduct a comprehensive study of Internet gambling and recommend alternative means of effectively regulating such gambling.

Two types of credit card organizations handle the four major U.S. credit cards: (1) credit card associations such as VISA International (VISA) and MasterCard International Inc. (MasterCard) and (2) full-service credit card companies such as American Express Company (American Express) and Discover Financial Services, Inc. (Discover). Credit card associations and full-service credit card companies vary dramatically in size, market reach, and organizational structure. As of December 31, 2001, for example, the two major credit card associations had dramatically higher numbers of issued credit cards than the major credit card companies (fig. 1).

Each of the two major associations in our review is owned by its member financial institutions. Around 21,500 member financial institutions own VISA, and about two-thirds of them are located in the United States. About 20,000 financial institutions participate in MasterCard worldwide. As described in a prior GAO report, MasterCard has a two-tier membership structure composed of principals and affiliates.¹⁷ Principal members have a direct membership relationship with the association and serve as sponsors to affiliates. For example, a U.S. or foreign bank can apply to become an affiliate member if a principal member agrees to sponsor the bank and the bank satisfies the association's membership criteria and clears the approval process.

While the associations do not provide credit card services directly to cardholders or businesses, they establish the operating standards that define the policies, roles, and responsibilities of their member institutions and provide the data processing and telecommunications systems that transfer transaction data between members. The member institutions issue the credit cards to customers, acquire (sign up) merchants to accept credit cards, or both, along with providing other services directly to the cardholders and merchants. Member institutions generally fall into two categories:

- Issuing banks that solicit potential customers, approve applications, and issue credit cards. These banks extend credit to cardholders, establish the terms of cardholders' accounts (for example, credit limits and treatment of delinquent accounts), collect debts, and maintain accounts and cardholder records.
- Acquiring banks that solicit potential merchants and approve and license merchants to accept credit cards. These banks, also known as merchant banks, enter into agreements authorizing merchants to accept the association's credit cards, submit their merchants' transactions into the association's system for payment from issuing banks, and maintain accounts and related records on their merchant clients.

Third-party processors are also part of the industry. They

contract with acquiring and issuing banks to provide transaction processing and other services. As part of the services they provide for their banking clients-- members of the credit card associations--processors block Internet gambling transactions and ensure that Internet gambling sites do not become approved merchants.

The two full-service credit card companies in our review, American Express and Discover, issue their own brands of cards directly to customers and authorize merchants to accept those cards. Discover, an affiliate of Morgan Stanley, provides primarily credit card services. American Express, a publicly held company, also provides travel, financial, and network services. Each company owns a U.S. bank. American Express and Discover assume primary responsibility for providing credit card services directly to both customers and merchants.

They perform all major aspects of issuing cards, including approving applications from customers, mailing cards to customers, authorizing transactions, and sending out bills. They also perform all major aspects of acquiring merchants to accept their cards, including signing up merchants, distributing credit card terminals, and settling merchant accounts. By acting as both issuer and acquirer, the two companies represent what the industry refers to as a ..closed loop.. system. Both companies own and operate the electronic networks that handle all information on transactions for cardholders and merchants.

American Express and Discover market their credit card business to consumers and potential merchants in the United States. Both companies issue cards to individuals, and American Express also issues cards to businesses. In addition, American Express has arrangements in some overseas markets to license foreign banks to issue its cards and acquire merchants. As of December 31, 2001, American Express had arrangements with 74 institutions located in 77 countries other than the United States. Both federal and state laws apply to Internet gambling in the United States. In general, gambling is a matter of state law, with each state determining whether individuals can gamble within its borders and whether gaming businesses can legally operate there. Since Internet gambling typically occurs through interstate or international means, with a Web site located in one state or country and the gambler in another, federal law is used to protect the states from having their laws circumvented. To date, the Wire Act is the federal statute that has been used to prosecute federal Internet gambling cases, although courts sometimes disagree on the applicability of certain provisions of the statute. In addition, the Travel Act and the Illegal Gambling Business Act have been used to prosecute gambling entities that take interstate or international bets over the telephone and would likely be applicable to Internet gambling activity. Some states have taken specific legislative actions to address Internet gambling, in some cases criminalizing it and in others relying on existing gambling laws to bring actions against entities engaging in or facilitating Internet gambling. Like the U.S. states, other countries have enacted laws that explicitly prohibit or permit Internet gambling under certain conditions or rely on existing laws to prosecute Internet gaming activity.

Although gambling regulation is generally left to the states, the federal government has the authority, under the Commerce Clause of the Constitution, to regulate gambling activity that affects interstate commerce.¹⁸ Internet gambling falls into this category, as bets are generally placed at a personal computer in

one state or country and received at a server in another state or country. Of the three federal statutes that appear to have direct applicability to on-line gambling--the Wire Act, the Travel Act, and the Illegal Gambling Business Act--to date only the Wire Act has been applied in the federal prosecution of activity relating to Internet gambling. The other two federal gambling statutes have been used in the closely analogous situation of telephone wagering, including telephone calls made to place wagers with offshore bookmakers.

The Wire Act prohibits gambling businesses from knowingly receiving or sending certain types of bets or information that assists in placing bets over interstate and international wires. Thus, if an Internet gaming Web site operating in any country (including the United States) receives a bet transmitted by an individual located in the United States, the operator has violated the Wire Act. For this reason, foreign entities offering gambling to U.S. citizens through the Internet would be subject to the Wire Act. Although some Internet gambling businesses, including foreign entities, have been successfully prosecuted under the Wire Act, courts do not agree on the applicability of certain sections of the statute.

First, individual courts have reached different conclusions about the types of gambling covered by the act. The statute prohibits the transmission of ..information assisting in the placing of bets or wagers on any sporting event or contest... This language has led some courts to interpret the Wire Act as covering bets only on contests that involve sports.

Second, the phrase ..transmission of a wire communication.. is somewhat ambiguous as it applies to the Internet. Depending on how the phrase is interpreted, the act might not apply to Internet gambling in some instances--for example, when information is only received over the Internet. Some courts have held that ..transmission.. means receiving as well as sending information, while others have held that it means only sending.¹⁹

Third, some disagreement exists among the courts concerning the second paragraph of the Wire Act, 18 U.S.C. § 1084(b), which provides that: ..[n]othing in this section shall be construed to prevent the transmission . . . of information assisting in the placing of bets or wagers on a sporting event or contest from a State or foreign country where betting on that sporting event or contest is legal into a State or foreign country in which such betting is legal...

In other words, transmitting information to assist in placing bets on a certain event is legal if two conditions are met: (1) betting on the event is legal in both the place where the transmission originates and the place where it is received, and (2) the transmission is limited to information that assists in the placing of bets--that is, it does not include the bets themselves.²⁰ Certain courts have stated that this language means that when the betting activity is legal in both jurisdictions, interstate gambling would not be a violation of the Wire Act.²¹ Most courts disagree with this interpretation of Section 1084(b), and based upon the language of Section 1084(b) and clear statements in the legislative history, DOJ disagrees with this interpretation as well.²²

Finally, the Wire Act mandates that a wire communication facility must be involved in order for a violation to occur. Currently, all Internet communications are dependent in some way on some

type of wire communication, such as telephone or data lines. Depending on how Internet technology develops, however, future Internet communications may no longer be wire communications covered under the Wire Act. The two other federal statutes with direct applicability to Internet gambling are the Travel Act and the Illegal Gambling Business Act. The Travel Act provides criminal penalties for anyone who undertakes interstate or foreign commerce with the intent to distribute the proceeds of any unlawful activity. The Illegal Gambling Business Act makes it a crime to operate an ..illegal gambling business...

The Travel Act imposes criminal penalties for those who utilize interstate or foreign commerce with the intent to distribute the proceeds of any unlawful activity. Under the Travel Act, unlawful activity includes any business enterprise involving gambling in violation of the laws of the state where the gambling takes place or of the United States. Thus, gambling over the Internet generally would violate the Travel Act because an interstate facility, the Internet, is used to conduct gambling.

The Illegal Gambling Business Act makes it a crime to operate an illegal gambling business, which is defined as any gambling business that meets three conditions:

- it violates a law of the state where it takes place,
- it involves at least five people (not even the same five people) at all times during a 30-day period, and
- it operates for the most part continuously for longer than 30 days or takes in gross revenues of \$2,000 in a single day.

Operating a gambling Web site for over 30 days in a state under the conditions described above would violate this act. A Web site could easily meet these conditions, including the requirement that at least five individuals be involved in its operation. The five people do not need to be directly involved in the gambling but must only be considered ..necessary and helpful.. to the operation. Computer operators, computer maintenance crews, accountants, and owners could all be included as ..necessary and helpful.. in the operation of an Internet gambling Web site.

Like the Wire Act, the Illegal Gambling Business Act applies only to gambling businesses, not individual gamblers. The Illegal Gambling Business Act does not require that the casino operators be convicted in state court, but the gambling activity must violate state law.²³ The proof requirements associated with the Illegal Gambling Business Act are minimal; the government must prove only that the business has met the three conditions.²⁴ The 30-day requirement is satisfied if there is a ..repeated pattern of gambling activity...²⁵

Two other statutes have some applicability to Internet gambling-- the Indian Gaming Regulatory Act (IGRA) and the Interstate Horseracing Act (IHA). Certain types of gaming on Indian reservations are permitted under IGRA, with the regulatory jurisdiction determining the type of gambling that is permissible. ²⁶ A recent case addressed some of the issues and raised the question of whether Internet gambling takes place on tribal lands when bettors who are not on tribal lands use their home computers to access Internet lotteries via computer servers that are. The case involved the question of whether the state of Missouri could prevent a Native American tribe in Idaho from accepting money from Missouri residents via a lottery Internet

site.²⁷ After dismissals, removals, and appeals, the case was eventually settled, but it is unclear whether the court resolved the issue of whether Internet gambling takes place on tribal lands when the Web site is located on those lands.²⁸ For more information on IGRA, see our interim report.²⁹

Pari-mutuel wagering on state-licensed horse races takes place over the Internet in a number of states.³⁰ Federal and state laws govern this activity. In 1978, Congress passed the IHA to regulate interstate commerce with respect to pari-mutuel wagering on horse races. The IHA provides that no person may accept an interstate off-track wager without the consent of the appropriate host racing association, the host racing commission, the off-track racing commission, and nearby race tracks. An interstate off-track wager is defined as ". . . a legal wager placed or accepted in one State with respect to the outcome of a horse race taking place in another State. . . . Parimutuel wagers fall into this category if they are legal in both of the states, are made by telephone or other electronic device, and are accepted by an off-track betting system in any state, as well as the combination of any pari-mutuel wagering interstate pools.³¹ The language of the statute appears to allow the electronic transmission of interstate bets as long as the appropriate consent is obtained.

Wagering on horses over the Internet is generally done using a closed-loop subscriber-based system designed to limit access. In March 2000, DOJ officials testified that it was a violation of the Wire Act for an entity to offer bets on horse races over the Internet; however, to date, DOJ has not brought any cases against any state-licensed horse racing tracks for accepting wagers from out-of-state bettors using the Internet or any other wire communication. In addition, IHA was amended in December 2000, after DOJ testified in March 2000 to explicitly expand interstate off-track wagers to include wagers through the telephone or other electronic media.³² For more information on IHA, see appendix II.

Five states (Illinois, Louisiana, Nevada, Oregon, and South Dakota) have enacted laws that specifically prohibit aspects of Internet gambling. In states that have not specifically enacted legislation prohibiting Internet gambling, existing state gambling laws could apply, and new legislation would not be necessary. For example, in states that prohibit all types of gambling, such as Utah, Internet gaming also would be illegal. In some states the status of Internet gambling is unclear, as laws may prohibit some types of gaming, but may not be interpreted as applying to Internet gambling.

We reviewed the gambling laws of five selected states-- Massachusetts, Nevada, New Jersey, New York, and Utah--to determine how their existing laws would affect Internet gambling. We chose these states because they have a wide range of gambling provisions, from total prohibition to allowing certain types of legalized land-based casino gambling. Massachusetts, for instance, has legalized dog and horse racing under the supervision of the state racing commission and certain statewide lotteries and raffles by certain organizations under the supervision of the State Lottery, a division of the state Treasury department. But Massachusetts law prohibits most other types of gambling, including transmitting a bet or wager using the telephone.

However, Massachusetts does not have a statute specifically addressing Internet gambling. Nevada has legalized land-based casino gambling, but Internet gambling is illegal. However, the

state has authorized the Nevada Gaming Commission to adopt regulations governing the licensing and operation of Internet gambling if the Commission determines that interactive gaming can be operated in compliance with all applicable laws. In New Jersey, gambling can be made legal only by referendum, and only land-based casino gambling in Atlantic City, licensed horse racing, state lotteries, bingo and raffles for certain groups, and amusement games have been approved via referendum. New York has authorized certain lotteries, certain types of pari-mutuel betting on horse races and bingo, lotto games, and local games of chance that operate under specific conditions, but prohibits most other types of gambling. Utah prohibits all forms of gambling, including state-run lotteries, and the Assistant Attorney General has stated that Utah believed that gambling of any type from a computer located in Utah would constitute gambling within the state. The attorneys general of New Jersey and New York have recently initiated actions or investigations against entities that either engage in or facilitate Internet gambling businesses. For more information on the approaches these states have taken to Internet gambling, please see our interim report.

Like the United States, a number of other countries have commissioned detailed reviews to determine the implications of gambling, including Internet gambling, within their countries. These countries take a variety of approaches to regulating Internet gambling. For a number of reasons, we were unable to determine how many countries explicitly prohibit Internet gambling. For example, gaming laws in many countries, like those in many U.S. states, apply to gaming in general rather than to Internet gambling. Although we were unable to determine the exact number, an interactive gaming industry services group reported that over 50 countries and foreign jurisdictions, mostly in Europe, the Caribbean, and the Australia/Pacific region, have legalized Internet gambling. To illustrate the different approaches countries take to regulating Internet gambling, we reviewed four jurisdictions: Australia, Canada, Hong Kong, and the United Kingdom (U.K.). Appendix III contains more detailed information about each of these jurisdictions.

In July 2001, following a year-long moratorium on the development of the interactive gaming industry, the Australian Parliament enacted the Interactive Gambling Act of 2001 that prohibits operators from providing an Internet gambling service to Australian residents. The act applies to interactive casinos and games on the Internet but does not apply to sports wagering or lotteries, which continue to be regulated by existing state and territorial legislation. It covers all interactive gambling service providers, including those based in Australia and offshore, and both Australian and foreign-owned businesses. The maximum penalty for violations is \$220,000 AUD (\$121,000 USD) per day for individuals and \$1.1 million AUD (\$606,000 USD) per day for corporate bodies.³³ The act also makes it an offense to provide such services to people in a ..designated country...--that is, one that has asked for and received that designation from the Australian Minister of Communication, Information Technology, and the Arts to prohibit interactive gaming operators licensed in Australia from offering services to its citizens.³⁴

The Criminal Code of Canada makes it illegal to gamble or conduct any gaming activities within Canada unless they fall within recognized exceptions set out in the Criminal Code. The exceptions include ..lottery schemes.. that are conducted and managed by a province (such as casinos and electronic gambling), a narrower range of lottery schemes that are licensed by a

province (to a charity, a fair or exhibition, and, rarely, to a private individual), bets made between individuals not engaged in the business of betting, pari-mutuel betting on horse races (regulated by the federal Minister of Agriculture) and some lottery schemes conducted in Canada on international cruise ships. Under the Criminal Code, only provincial governments are permitted to offer a lottery scheme on or through a computer and only to residents of that province; they may not license others to conduct one. Therefore, in order to offer on-line gambling in Canada, a provincial government would have to operate the sites itself.

It would also need to ensure that residents of other provinces could not participate unless cooperative agreements existed.

In addition, commercial land-based betting on single sporting events is prohibited in Canada and therefore would not be permitted over the Internet. A recent case from the Prince Edward Island Supreme Court (Appeal Division) held that an Internet lottery ticket Web site licensed by the Province of Prince Edward Island would not be conducted and managed in the province as required by the Criminal Code. The court found that even though the server was located in the province, the lottery would violate the Criminal Code by offering gambling to a worldwide market. In addition, since it was licensed to a charity and not conducted by the province, it violated the Criminal Code requirement that only provinces conduct computerized lottery schemes. This case is now on appeal to the Supreme Court of Canada.

Gambling is unlawful in Hong Kong unless specifically permitted by law. In May 2002, the Hong Kong Legislative Council voted to ban offshore gambling, including offshore Internet gambling, by passing the Gambling (Amendment) Ordinance. This law makes both offshore betting and bookmaking criminal offenses and provides for criminal penalties against offshore gambling agents that promote, facilitate, or advertise their products to Hong Kong residents. The maximum punishment for brokers is 7 years in prison and a penalty of \$5 million HKD (\$641,000 USD), while individual bettors face 9 months in prison and a penalty of \$30,000 HKD (\$3,800 USD).³⁵ However, it is legal for the Hong Kong Jockey Club--the legal gambling monopoly--to offer its services on-line to Hong Kong residents.

The U.K. has several laws and regulatory schemes that apply to gambling, but there are no specific laws governing Internet gambling. Some forms of gambling can be carried out on the Internet under existing law, while others cannot. In July 2001, the UK Gambling Review Body published its report (..the Budd Report..), which states that prohibiting on-line gambling by British consumers would be an unrealistic objective. In response to the Budd Report, the UK's Department for Culture, Media, and Sport is working to develop a timetable for introducing new gambling legislation sometime between 2003 and 2004. The new legislation is to contain a number of major gambling reforms, including legislation on Internet gambling.

Full-service companies and credit card associations have taken different approaches to restricting the use of their cards for Internet gambling. Credit card companies have focused primarily on prohibiting Internet gambling sites from becoming credit card merchants. Credit card associations and their members have focused primarily on facilitating the blocking of Internet gambling transactions. Most large U.S. association members that issue credit cards told us that they have chosen to block these

transactions. For a variety of reasons, however, they cannot always identify all Internet gambling transactions. For example, both association and bank officials told us that some gambling Web sites deliberately miscode gambling transactions. The credit card associations monitor transactions and take action against acquiring banks when they are not properly coding Internet gambling transactions. In addition, U.S.-based acquiring banks that belong to associations do not acquire Internet gambling merchants as customers, although association members in other countries do.

American Express and Discover have companywide policies that restrict the use of credit cards for Internet gambling, but officials stated that the restrictions apply to all gambling activities because the companies do not, as a matter of policy, want to do business with what they consider to be a high-risk industry. Both credit card companies have developed specific procedures to help ensure that Internet gambling sites do not become credit card merchants. First, Internet businesses applying to become merchants are screened, generally through routine visits and reviews of the applicants. Web sites, to verify that they have accurately represented the business they are in and are not engaged in any gambling activities.

Second, existing Internet credit card merchants are monitored to ensure that they do not discreetly transform into Internet gambling sites-- something that, according to officials, has happened. One credit card company told us that it had contracted with a third-party vendor to help implement an Internet monitoring system designed to identify improper use of its card. This initiative entailed identifying and testing Internet gambling sites attempting to secure payments using the company's credit card, including existing merchants that may have expanded into Internet gambling activities. Company officials noted that the vendor had also identified several Internet gambling sites that were illegally using the company's logo to give the sites legitimacy. The second company told us that it uses its own employees, rather than an outside vendor, to conduct similar reviews of Internet gambling sites in general and of the company's existing Internet merchants in particular. The results of our survey of Internet gambling Web sites showed that most do not promote full-service credit card companies, although the cards were advertised as a possible form of payment on 8 of the 162 we reviewed.³⁶ Appendix IV provides additional information on our survey.

In spite of these efforts, credit card company officials recognize that some Internet gambling sites that attempt to secure credit card payments may still go unidentified. Thus, as part of their overall efforts to monitor fraud, both companies have also implemented procedures to monitor transactions for patterns that might indicate that credit cards are being used for Internet gambling activity. However, like issuing bank officials, credit card company officials acknowledged that identifying Internet gambling transactions after the fact is difficult. They also agreed that online payment providers present a challenge to credit card companies that are trying to restrict the use of their cards for Internet gambling. ³⁷ Officials for both companies stated that they had reached an agreement with one major on-line provider stipulating that the provider would block Internet transactions using the companies' technology and were working on similar agreements with other on-line payment providers.

Neither VISA nor MasterCard has issued policies to its members that restrict the use of the association's credit cards for Internet gambling. Instead, both associations have developed procedures that enable member banks wanting to block Internet gambling transactions to do so. Officials from both associations explained that reaching a consensus on a blanket policy among members around the world would likely be difficult. Some members are located in countries where Internet gambling is legal and, according to one official, represents an expanding business market. Policy decisions to restrict the use of credit cards for Internet gambling are therefore left to the discretion of individual member institutions. Association officials note, however, that their members agree with operating regulations for both VISA and MasterCard stipulating that only legal transactions may be introduced into the systems.

VISA and MasterCard have each developed a system of coding that allows member institutions, at their discretion, to block Internet gambling transactions. Both associations have had a long-standing uniform coding system designed to facilitate the processing and authorization of credit card payments for member banks. About 4 years ago, the associations refined their systems to include a cross-indexed scheme of merchant and commerce codes so that Internet gambling transactions could be identified. Internet gambling merchants that accept VISA or MasterCard payments are required to use a combination of a gaming merchant category code and an electronic commerce indicator code. These two codes, which are transmitted through the credit card network to the card issuer as part of the requested authorization message, inform the card issuer that the transaction is an Internet gambling transaction. The issuer can then deny authorization.

Officials explained that the coding system informs card issuers that the transaction is an Internet gambling transaction but cannot signal whether the particular transaction is legal or illegal. The existing coding system does not capture enough information to distinguish between legal and illegal Internet gambling transactions. Moreover, an official pointed out that the distinction between legal and illegal transactions is difficult to make because of the complexities involved in determining which laws govern any particular Internet transaction and the practical limitations of determining where a cardholder may actually be when engaging in the transaction. As a result, a member bank's decision to block Internet gambling transactions may result in blocking all properly coded Internet gambling transactions--both in jurisdictions where on-line gaming is legal and illegal. For example, a U.S. cardholder may visit a country where Internet gambling is legal and, while there, attempt to use a credit card to pay for on-line gambling transactions. If the credit card issuer has chosen to block Internet gambling transactions and the transaction has been properly coded, authorization for payment will be denied.

Although the credit card issuer is responsible for making the policy decision on whether to deny authorization for Internet gambling transactions, actual blocking of transactions can occur at different points in the credit card transaction process. In some cases, the issuer has asked the association to block the transactions on its behalf. Other issuers do the blocking themselves, while still others instruct their third-party processors to do the blocking (fig. 2).

Information on the number of member institutions belonging to

credit card associations that have opted to systematically block Internet gambling transactions is not readily available. However, association officials noted that many of the largest U.S. credit card issuers have chosen to follow this course of action. Officials from the eight large U.S.- based issuing member banks we reviewed, which represent more than 80 percent of the purchase volume of cards issued by VISA and MasterCard in the United States, all indicated that they had implemented policies to deny payment authorization for Internet gambling transactions coming through their automated systems. Officials of a trade association for community banks and the processor of its members. credit card transactions stated that most, if not all, of the small community bank issuers had also chosen to block Internet gambling transactions. However, some association members--primarily those in foreign jurisdictions where Internet gambling may be legal--continued to acquire Internet gambling sites as merchants.

The eight issuing banks in our review implemented their blocking policies between the early months of 2000 and June 2002. Internet gambling transactions can be blocked in two ways: either the issuer blocks the payment directly, or another party, such as a third-party processor or an association, does it instead. Five of the eight issuers told us that they blocked Internet gambling transactions themselves; the other three relied on a major third-party processor or an association to block on their behalf. Issuers that do their own blocking stated that by doing the blocking themselves, they were able to maintain control over transactions. For example, they were able to perform their own risk management of these transactions or contact their customers to discuss the transactions.

Officials at two issuing banks told us they believed that authorizing or denying all transactions themselves gave them a better chance of catching Internet gambling merchants seeking to disguise the transactions. Although denials of payment for Internet gambling had decreased significantly since the company began blocking Internet gambling transactions, an issuing bank official noted that, in the previous quarter, their system had identified eight merchants that were conducting inappropriate activities, including disguising Internet gambling transactions.

One of the major reasons some issuers gave for their decision to block Internet gambling transactions was their belief that Internet gambling is a high-risk industry, vulnerable to fraud and other illegal activities. Most of the issuing banks explained that they blocked Internet gambling transactions primarily because of on-line gambling's unclear legal status, which they believed could cause them to unknowingly facilitate illegal Internet gambling, and because of the financial impact (for example, potential legal costs and charge-offs) that could result if the customers refused to pay their gambling charges. 38 Since the legality of Internet gambling is questionable, debts incurred through such activities may be unenforceable. Using this argument, some bettors have refused to pay their gambling debts, claiming that the issuing banks facilitated the ..illegal.. activities. In addition, in a number of lawsuits in U.S. courts, bettors have claimed that the credit card issuer is liable for allowing bettors to use its services for an illegal activity under state law. In one case, the bank that had issued the credit card sued the bettor when the bettor refused to pay the credit card bills for her gambling losses. In a countersuit, the bettor claimed that the bank was liable for letting the bettor gamble with the credit card when such gambling activity was illegal in her state. The case was settled before the trial. One of the

provisions of the settlement required the Internet gaming sites to pay the bettor.s Internet gambling debts to the banks that issued the credit cards. Half of the issuing banks in our review told us that they have explicit disclosures in their cardholder agreements stating that their cards cannot be used for Internet gambling and two of these banks said they had added the explicit reference only recently because of these lawsuits. Other issuing banks said that their cardholder agreements state that their cards cannot be used for illegal activities but do not specifically mention Internet gambling.

According to gaming analysts, issuing banks. efforts to block Internet gambling transactions could reduce the projected growth of the Internet gaming industry from 43 to 20 percent.³⁹ What was estimated to be a \$5.0 billion industry worldwide could now be reduced to \$4.2 billion.⁴⁰ In the meantime, some Internet casino operators now estimate that four out of every five requests for credit card payments are denied.

Association and banking industry officials told us that the effectiveness of efforts issuing banks make to block transactions involving Internet gambling depends on the integrity of the associations. coding systems as implemented by merchants and acquiring members throughout the world. However, the coding systems can be compromised in two ways: (1) by Internet gambling merchants that attempt to disguise transactions by miscoding them, and (2) by cardholders who attempt to circumvent the system by using on-line payment providers.

According to an association official, Internet gambling merchants have a strong incentive to miscode and thus try to disguise their transactions since proper coding could result in a denial of authorization. Circumventing the coding system in this way, according to the issuers, presents a significant challenge. Issuers have no control over the merchants and no way to immediately identify and block all such transactions. Issuing bank officials emphasized the difficulty of identifying attempts to conceal Internet gambling transactions, regardless of any proactive efforts to find instances of miscoding. One official noted that some disguised Internet gambling transactions are identified only by chance, if at all. Most of the issuers acknowledged that Internet gambling merchants have circumvented the coding system primarily by submitting improperly coded transactions that do not represent Internet gambling or by failing to use the electronic commerce code. In some cases, a merchant engaged in more than one business has a secondary merchant code available and uses it to code what is really an Internet gambling transaction. In other cases, a merchant moves into Internet gambling after having been accepted by the acquirer as a different type of business.

Unless the acquirer monitors the merchant, it will not know that the merchant is actually processing Internet gambling transactions. Two issuers noted that Internet merchants are able to circumvent the coding system by engaging in factoring.⁴¹ According to the issuers, factoring occurs when a merchant, possibly one engaged in Internet gambling, submits credit card transactions through another merchant.s terminal using that merchant.s identification number and merchant category code, and pays that merchant a percentage of the submitted transactions. Officials from both associations agreed that factoring as described by the issuers can be used to circumvent the coding system and violates the associations. rules. They also noted that this type of factoring is distinguishable from legitimate

factoring. An issuer told us that in one case a merchant circumvented the coding system by setting up a bogus site and processing numerous transactions using a telephone and rogue terminal. The issuer believed this situation could have been avoided if the acquirer had exercised adequate due diligence on the merchant.⁴²

Issuing banks also viewed as problematic cardholders. use of on-line payment providers or payment aggregators to pay for Internet gambling activities. These entities enable consumers to use their credit cards to set up accounts with many kinds of Internet-based merchants, including online casinos. The issuers indicated that while on-line payment providers did not circumvent the coding system, most aggregators. transactions were not coded to reflect the purpose or type of transaction such as Internet gambling. Because credit card transaction codes can be obscured as the transactions pass through such intermediaries, issuing banks cannot determine whether credit card funds are being used for Internet gambling.

Nevertheless, most of the issuers said they would continue to accept credit card transactions from payment aggregators because they believed that these transactions were mostly legitimate or because the transactions represented a very small percentage of their total volume of credit sales. Officials from one major U.S. payment aggregator told us, recognizing the potential for abuse, that they had established policies in accordance with the U.S. Department of the Treasury's Suspicious Activity Reporting requirements and file reports weekly.⁴³ Additionally, one issuer expressed confidence in conducting business with a leading U.S. aggregator, PayPal, because this aggregator no longer does business with Internet gambling merchants.

Our survey of Internet gambling Web sites, conducted during summer 2002, showed that four different payment providers were advertised as payment options. The one that appeared most often, PayPal, was on twothirds of the sites in our survey, while the one that appeared the least frequently, EZPay, was on about 1 percent of the sites. In some cases, the sites suggested that gamblers use an on-line payment provider to fund their accounts if their credit cards were blocked. We also found instances of the sites offering bonuses to gamblers who chose to fund their accounts through on-line payment providers.

Rather than developing an audit program to address Internet gambling issues, one association chose to focus on dealing proactively with these on-line payment providers, which it viewed as a potential loophole in the system. An official from one association explained that the association had a policy of not doing business with on-line payment providers without reaching an understanding about Internet gambling with the provider's acquirer. The acquirer would have to agree that any funds the provider obtained through the association's systems would not be used for Internet gambling unless the transaction was properly coded, so the issuing bank could deny the charge at its discretion. The official cited an example in which such an understanding could not be reached. The provider stopped accepting cards bearing the association's brand name rather than comply with the coding requirements.

Officials of the other association noted that on-line payment providers are responsible for ensuring that credit cards are not used to pay for Internet gambling activities unless the funds transfer is explicitly coded as an Internet gambling transaction

at the time of the authorization. In such cases, issuers that have decided to block Internet gambling transactions can deny authorization for those made through an on-line payment provider. Officials were aware that at least one major on-line payment provider was regularly using the Internet gambling transaction codes when they were warranted.

Issuers learn from customer complaints or their own monitoring that a credit card transaction is a disguised Internet gambling transaction. The issuers we spoke with told us that they used their fraud monitoring systems to identify potential Internet gambling transactions. The systems, according to the issuers, provide initial clues by identifying deviations from expected patterns of transactions, and the issuers investigate these deviations for potential Internet gambling transactions. Some issuers told us that they also periodically reviewed and analyzed authorization logs generated by their systems for departures from established operating rules. Several issuers noted that they also identified Internet gambling transactions from investigating customer disputes. Most of the issuers said that as a result of their total monitoring effort, they ultimately were able to identify Internet gambling merchants that miscoded transactions to disguise them and had programmed the monitoring systems to identify, track, and block these merchants' transactions. Two issuers told us that in egregious cases they blocked the merchant's identification number and thus denied all transactions from that source. But the issuers acknowledged that their monitoring efforts did not capture all transactions involving Internet gambling and could not always identify where the transactions took place.

Issuers can take other actions against Internet gambling merchants that they identify as cloaking transactions. First, if they learn about the Internet gambling activity within the time limits established by association rules, some issuers attempt to charge the transactions back to these merchants.⁴⁵ One issuer said that it used a modified chargeback procedure that required searching posted billing transactions for indications that Internet gambling might be involved. The issuer reportedly was able to charge back hundreds of thousands of improperly coded transactions, putting several Internet gambling operators out of business. The issuers also told us they reported the Internet gambling merchants to the credit card associations so that the associations could notify the acquiring banks, which could exercise due diligence over the merchants.

The six acquirers in our review were all U.S.-based members of the credit card associations. Officials from five of these acquirers told us they do not have any overseas operations, and five indicated that, as a matter of policy, they acquire merchants only in the United States. Because Internet gambling merchants tend to be located overseas, these U.S.-based acquirers would not acquire these merchants in any case. One of the other acquirers told us it had relationships with foreign merchants through arrangements with foreign banks but did not acquire Internet gambling merchants overseas. According to an association official, member banks based outside the United States acquire Internet gambling merchants in jurisdictions where Internet gambling may be a legal enterprise. The associations did not conduct any additional due diligence on member banks that acquired Internet gambling merchants. One association provided its members with additional requirements and best practices for acquiring such merchants.

Based on our survey of Internet gambling sites, we estimate that about 85 percent advertised MasterCard as a form of payment, with a similar percentage of sites advertising VISA. However, although Internet gambling sites may advertise a specific association, such as VISA or MasterCard, transactions using the cards of issuing banks that attempt to block Internet gambling may be denied. Some of the sites in our survey alerted their clients to this potential problem and suggested the use of other payment options, including on-line payment providers, wire transfers, and checks. Some Internet gambling Web sites offer bonuses to promote payment mechanisms such as direct wire transfers. In our review, about 47 percent of the Internet gambling sites advertised Western Union. Our survey also revealed that Internet gambling Web sites encouraged the use of money orders and various forms of checks--about 28 percent of the reviewed sites said they allowed money orders, while 8 percent said they accepted traveler.s checks. In addition, 40 percent of Internet gambling Web sites noted that they would recognize bank drafts, certified checks, and cashier.s checks. Our survey results also showed that 79 of the sites reviewed indicated they had established a relationship with an electronic banking system or a processor. Appendix IV provides more information on our survey.

U.S.-based acquirers told us that they exercised due diligence on Internetbased merchants to ensure that the merchants were not engaged in Internet gambling. The acquirers. due diligence of Internet merchants consisted of screening applicants and monitoring approved merchants. In screening merchant applicants, the acquirers generally verified applications and reviewed Web sites to ensure that the merchants were not engaged in Internet gambling. Two acquirers also said that they reviewed merchants. business plans and products to understand the nature of the operations and determine if international transactions would occur in the course of the business. The acquirers in our review said they assigned approved merchants a merchant category code identifying the type of business activity the merchant was engaged in and required them to use the code to transmit credit card transactions. Individual merchants engaged in more than one type of business activity could receive more than one code.

The acquirers. monitoring efforts included periodic visits to the Web sites of approved merchants to ensure that the nature and distribution of their products had not changed. They also analyze any changes in merchants. transaction volumes and transactions for all e-commerce sites. Most of the acquirers told us that they were unable to screen out all Internet gambling merchants despite these due diligence efforts. Acquirers gave different reasons for not detecting all Internet gaming merchants. For example, two acquirers cited factoring, while others cited merchant fraud or misrepresentation of business activity. While the acquirers in our review did not deny that Internet gambling merchants had circumvented the coding system by entering erroneous merchant category codes, they denied direct knowledge that their Internet merchants had engaged in this activity. Nevertheless, the acquirers told us that as a matter of policy they would terminate merchants that were found repeatedly miscoding credit card transactions or misrepresenting their activities.

Association officials told us that both of their associations monitored transactions for fraud, looking for and investigating suspicious activity. These monitoring efforts, which may identify miscoded transactions from Internet gambling merchants, are designed to detect many different types of fraudulent schemes. Association officials also noted that consumer complaints and

concerns raised by issuers had been helpful in identifying coding errors related to Internet gambling.

Associations. efforts in support of issuer policies to block Internet gambling transactions focused primarily on requiring acquiring member banks to ensure the accuracy of merchant and commerce codes. The associations did not monitor the adequacy of due diligence exercised by acquiring banks in screening and monitoring merchants. They relied on federal and state banking regulators to supervise and examine acquirers. due diligence and ..expected.. the acquiring banks to comply with association contracts, agreements, and operating regulations. The regulations specifically impose on all acquirers the responsibility for ensuring that their merchants properly code transactions and impose penalties on the acquirers for improper merchant and transaction codes.

Association officials said that they shared the results of their investigations of merchants with acquirers, enabling the acquirers to take action against these merchants. For example, an official said that his association had detected several instances in which merchants had submitted false information on applications and thus had been assigned category codes for businesses other than gambling. The association said that it had told the acquirers about these merchants and that the acquirers promptly terminated them.

In November 2001, one of the credit card associations implemented an Internet gambling audit program to help minimize the extent of coding errors related to Internet gambling. Rather than monitoring actual transactions, the program focuses on monitoring Internet gambling Web sites to identify merchants that may be disguising their credit card transactions. The association.s staff sample Internet gambling Web sites and test the reliability of their coding efforts by submitting ..dummy.. transactions. If the testing reveals that a gambling site uses incorrect coding, the merchant.s acquirer is notified and given 30 days to correct the coding with the merchant. The association then audits the site to verify that the coding has been corrected. When an Internet gambling merchant is cited for using incorrect codes, the responsible acquiring bank can be fined \$25,000 per merchant outlet. To date, the association has imposed more than \$100,000 in penalties on six acquiring banks for improper coding by merchants.

Two of the four third-party processors in our review told us that they blocked Internet gambling transactions for their issuing bank clients. Three of these processors also told us that while they acquired Internet merchants on behalf of their acquiring bank clients, they did not acquire Internet gambling sites because their clients did not want these merchants as customers. The processors noted that they always carried out the policies and procedures specified by the issuing and acquiring clients regarding the types of transactions to block or the types of merchants to acquire.

The processors provided a variety of services for their client banks. For example, they provided software programs, technical assistance, fraud monitoring, e-banking services, and services related to card processing, such as issuing cards, authorizing transactions, and billing customers. The three processors providing merchant acquisition services said that they conducted due diligence on the Internet merchants, screened merchant applicants and monitored those approved. The three processors

said that their screening procedures required due diligence to ensure that the new Internet merchants were not engaged in Internet gambling. Officials of one of these processors underscored their view that Internet gambling sites represented a significant financial and legal risk and said that the company did complete Web site reviews to evaluate merchants, practices and confirm the types of products sold. The two other processors also provided monitoring services, including on-going reviews of merchants, Web sites and changes in merchants, transaction activity, to verify whether these businesses had expanded into Internet gambling.

With financial institutions restricting the use of credit cards, many gaming representatives believe that e-cash will become the currency of the future for Internet gambling. E-cash comes in two basic forms: smart card e-cash and computer e-cash.⁴⁶ A report on emerging cyberspace technology outlined the four types of cyberpayment systems that exist; however, they are not all currently in use for Internet gambling. The models are the merchant issuer model, the bank issuer model, the nonbank issuer model, and the peer-to-peer model.⁴⁷

- The merchant issuer model. The merchant issues the smart card. An example of this model can be found in the subway system in Washington, D.C., which sells Smart Trip farecards directly to riders for use on the subways. Riders can simply add money to the cards and continue using them.

- The bank issuer model. A financial institution issues the smart card, and the transactions are cleared through the traditional financial systems.

- The nonbank issuer model. Users buy electronic cash from issuers using traditional money and spend the electronic cash at participating merchants. The issuer subsequently redeems the electronic cash for the merchant.

- The peer-to-peer model. A bank or other entity issues electronic cash, which is then transferred between users. The only points of contact between the traditional payments system and the electronic cash are the initial purchase and the redemption from the individual or merchant. Representatives of the Internet gambling industry noted that while using ecash is not as convenient as using credit cards, it does offer advantages.

For example, there are no global constraints, transaction costs are lower, transactions are processed immediately, and the risk of identity theft is substantially lower. However, in their view, in the United States, e-cash has struggled because U.S. citizens are comfortable using credit cards for e-commerce and thus have not generally used alternative payment mechanisms. But, according to Internet gambling representatives, as financial institutions increasingly block credit card transactions for Internet gambling, they expect the demand for alternative payment methods will increase. Further, one gaming analyst commented that because the Internet gambling market is saturated, many business plans now being presented to Internet gaming consultants are proposals for alternative payment systems, including digital cash, Automated Teller Machine features, digital cards, affinity cards backed by acquiring banks, and automated clearinghouse systems and transfers.⁴⁸ According to the gaming analyst, market demand is driving the industry to shift away from establishing Internet gambling Web sites and toward developing payment mechanisms.

Representatives of law enforcement agencies, regulatory bodies, and the credit card and gaming industries expressed mixed views regarding the vulnerability of Internet gambling to money laundering. Law enforcement officials believed that money laundering activities could potentially be conducted on both legitimate and complicit Internet gambling sites.⁴⁹ Representatives of the credit card and gaming industries believed that Internet gambling was not necessarily more susceptible to money laundering than any other type of on-line transaction. However, gaming industry representatives suggested that eliminating traditional forms of payment such as credit cards could potentially heighten money laundering concerns.

Law enforcement officials told us they believed that Internet gambling can be a significant vehicle for laundering criminal proceeds, especially to move illicit funds among financial institutions at the layering stage. The officials said that the volume, speed, and international reach of Internet transactions and the fact that many Internet gambling sites are located offshore increased the potential for misuse. In their view, these characteristics can promote a high level of anonymity and give rise to difficult jurisdictional issues.

Law enforcement officials acknowledged the lack of adjudicated cases involving money laundering but said they believed that Internet gambling offered many potential ways of laundering money. One U.S. law enforcement official attributed the lack of adjudicated cases involving money laundering through Internet gambling sites to several factors, most notably the lack of any industry regulations or oversight. Currently, the Federal Bureau of Investigation (FBI) has two open cases involving Internet gambling as a venue for money laundering activities.

In Treasury Enforcement's view, one key reason that Internet gambling is vulnerable to money laundering and other forms of financial crime, including tax evasion, is that the gambling sites are frequently located in areas with weak or nonexistent supervisory regimes. The U.S. experience with all types of money laundering is that criminals will seek out and exploit areas of the world with ineffective supervisory regimes. The multinational Financial Action Task Force (FATF)⁵⁰ has also noted this trend and, according to Treasury, initiated the Non-Cooperative Countries and Territories process to help bring countries with weaker anti-money laundering laws and supervisory regimes up to international norms. Although specifics were not provided, a February 2001 FATF report stated that some member jurisdictions had evidence that criminals were using Internet gambling to launder their illicit funds.⁵¹ In a March 2002 report, the State Department said that Internet gambling involving credit cards and offshore banks was a powerful vehicle for criminals seeking to launder funds from illicit sources and to evade taxes.⁵²

Treasury Enforcement officials also noted with concern how certain gaming merchants have attempted to circumvent the credit card coding system through factoring. In appropriate circumstances, they believed the use of factoring could be a key step in facilitating money laundering, since factoring is used to disguise from enforcement and regulatory officials the true source of funds and how they were obtained.

In the FBI's view, because of the nature of Internet gambling, money laundering could be conducted through either legitimate or complicit sites. In law enforcement's view, legitimate Internet

gambling sites provide an opportunity to transfer high volumes of money in and out of a number of accounts within a single institution... An individual could potentially deposit illicit funds into a legitimate Internet gambling account under a false name and wager a small amount in order to make the account appear genuine to the site operator. After a few losses, the individual could withdraw the rest of the illicit funds from the account. The transaction's paper trail would register a lawful Internet gambling transaction, mingling legitimate money with illicit. For example, a bettor who wanted to launder \$100,000 could potentially place bets on opposing teams in a sporting event with two different sites, betting on both teams for \$100,000. Regardless of the outcome, and if the bet were structured properly, the bettor would lose the bet wagered on the losing team but be paid double for the bet on the winning team. The only money that the bettor would lose would be the processing charges and related fees, and the money would appear to be legitimate winnings.

In addition, law enforcement officials believe a money launderer would not necessarily have to place a wager in order to clean illicit funds. A legitimate on-line gaming account could be used as a potential storehouse for illicit funds until they could be transferred to an offshore account. For instance, a money launderer could locate several legitimate Internet gambling sites that had few or no deposit requirements and deposit the maximum amount at one or more of them. The funds could later be transferred into an offshore account as legitimate winnings.

U.S. law enforcement officials said they also believed that money launderers could develop Internet gambling sites for the sole purpose of laundering money. An operator of a complicit site could theoretically program casino gaming software to react to a specific password or sign-on command, automatically taking a percentage of the deposit and cloaking it as a gaming loss. In essence, however, such a deduction would be the operator's service fee for laundering the illicit funds. Such a site would also need legitimate gamblers in order to mask the true nature of the operation.

Banking and gaming regulatory officials did not view Internet gambling as being particularly susceptible to money laundering, especially when credit cards, which create a transaction record and are subject to relatively low transaction limits, were used for payment. Likewise, credit card and gaming industry officials did not believe Internet gambling posed any particular risks in terms of money laundering. As noted earlier, the credit card industry has other reasons for restricting the use of credit cards in Internet gambling transactions. The associations, a credit card company, and a few issuers told us that they believed their broad anti-money laundering program or coding system covered potential money laundering through Internet gambling. Officials of one association specifically told us its transaction coding system for Internet gambling was designed to address risks, including money laundering, by allowing issuers to block any and all Internet gambling transactions. This system does not, however, enable issuers to block transactions that are not properly coded.

In general, gaming industry officials did not believe that Internet gambling was any more or less susceptible to money laundering than other electronic commerce businesses and noted that the financial industry-- which is responsible for the payments system--is better suited to monitoring for related

suspicious activity in the area than the gaming industry itself. A few officials commented that, in their view, on-line casinos should probably be subject to anti-money laundering requirements similar to those required of brick-and-mortar casinos. One U.S. gaming establishment has obtained an Internet gambling license and has begun offering Internet gambling from a jurisdiction with legalized and strictly regulated Internet gambling. To avoid jeopardizing the status of its U.S. state gaming license, this entity was trying to anticipate and address all the potential risks of expanding into Internet gambling, including any reputational risks that could be associated with money laundering.

Industry gaming officials also cautioned that, in their view, Internet gambling could become more susceptible to money laundering as U.S. financial institutions continue to block the payment of Internet gambling activities through credit cards. They explained that credit cards would likely be replaced by newer forms of electronic payments that might not be subject to the same level of record keeping or transaction limits as credit cards and could thus be more susceptible to money laundering. In these analysts' view, the new payment methods are attractive to Internet gamblers because they offer certain advantages: security, lower transaction costs, anonymity, and speed. These are important marketing tools for the Internet gambling industry.⁵³ However, the very features that appeal to Internet gamblers offer the potential to bypass traditional money laundering controls, possibly creating an ideal vehicle for money laundering. In addition, officials pointed out the likelihood that some emerging electronic gambling schemes that made identifying gamblers and enforcing regulations more difficult would become more popular. Such schemes could include, for example, player-to-player wagering that allows individuals to place bets directly with other bettors without involving a bookmaker or operator. According to gaming officials, the absence of the bookmaker or operator who normally assigns the odds or monitors the betting action increases the potential for illegal activity, including money laundering.

We requested comments on a draft of this report from the Departments of Justice and the Treasury. DOJ had no comments on it. Treasury provided technical comments on the money laundering section that we incorporated, where appropriate.

We are sending copies of this letter to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs and to the Ranking Minority Members of the House Subcommittee on Financial Institutions and the House Subcommittee on Oversight and Investigation, Committee on Financial Services. This report will be available on GAO's Internet home page at <http://www.gao.gov>.

Please contact Barbara Keller, Assistant Director, or me at (202) 512-8678 if you or your staff have any questions concerning this work. Key contributors to this work are acknowledged in appendix V.

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