
**REGULATING PUBLIC MORALS AND PRIVATE
MARKETS: ONLINE SECURITIES TRADING, INTERNET
GAMBLING, AND THE SPECULATION PARADOX**

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INTRODUCTION

Risk-taking is a distinctively American value.¹ From the frontier spirit of the settler to the entrepreneurial sense of the founder of a start-up company, Americans have been taught to realize “nothing ventured, nothing gained.”² This embracing of risk prompts individuals in the United States to participate in two closely intertwined activities: gambling and investing.

¹ RICHARD O. DAVIES & RICHARD G. ABRAM, *BETTING THE LINE* 146 (2001) (quoting sociologist James Frey as saying, “Risk is a very significant part of our lives. . . . People don’t want to admit it, but a great part of gambling is consistent with the American way.”).

² *See id.* (quoting psychologist Robert Custer as saying, “The Americans came in as the pioneers, the risk takers. They don’t mind taking the risk, and they will take the consequences.”).

To characterize investing as gambling has become a trite and toothless analogy. However, most worn-out proverbs remain in the conventional wisdom because a kernel of truth continues to resonate with those who heed them. In fact, the stereotype of an investor as a gambler seems particularly well deserved. To gamble is to put something of value at risk on an uncertain outcome; in other words, “Wagers are economic choices under uncertainty.”³ Under this broad definition, investors gamble with every purchase of a financial instrument.⁴ In making a securities purchase, some investors buy common stock of a corporation because they have studied that company’s business plan, find that model to be superior to the company’s competitors, and believe that the company’s managers will continue to increase profits, thus raising an undervalued stock price.⁵ Conversely, some investors buy stock not because they assess positive public information but because they have a good feeling.⁶ Others may buy stock merely because they know that others have bought the same or similar stock with some measure of success.⁷ Still others choose to buy or sell stocks based solely on a prediction of whether others will buy or sell.⁸ In other words, many investors buy stock for some of the same reasons that gamblers may choose certain slot machines, lottery numbers, or squares on a roulette table, or choose to bet or fold a certain poker hand.

Although many investors act as gamblers, both law and society view investing and gambling quite differently. Regulators characterize investing as an enterprise of skill in which the assiduous and diligent may earn deserved rewards.⁹ Conversely, gambling is viewed as an enterprise of chance that

³ Antonio M.R. Vernón, Market Efficiency and March Madness: Empirical Tests of Point Spread Betting 1 (Dec. 23, 2003) (unpublished manuscript, on file with the Social Science Research Network), available at <http://ssrn.com/abstract=340820>.

⁴ See Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 401-12, 416-18 (2005) (comparing investing, hedging, insurance, and gambling as risk-taking activities).

⁵ See Lynn A. Stout, *Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?*, 75 WASH. U. L.Q. 791, 803-05 (1997) (commenting that these “information arbitrageurs” may be outnumbered by speculators).

⁶ See Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, J. ECON. PERSP., Spring 1990, at 19, 23 (describing uninformed traders who respond to “pseudo-signals,” such as the advice of “financial gurus”).

⁷ This type of “noise trading” can be described as “trend chasing” or “positive feedback trading.” *Id.* at 23, 29.

⁸ *Id.* at 29-30 (describing the tendency of arbitrageurs to “jump[] on the bandwagon” by predicting where investor sentiment is going and when it will stop).

⁹ See U.S. Securities and Exchange Commission, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, available at <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 20, 2006) (“The world of investing is fascinating and complex, and it can be very fruitful. . . . [I]nvesting is not a spectator sport. By far the best way for investors to protect the money they put into

encourages the lazy and untalented to divert useful capital into a chaotic system whereby an undeserving few reap ill-gotten gains while the vast majority foolishly lose.¹⁰ In stock market investing, the financial intermediaries are viewed as earning modest fees for assisting others to invest wisely, but in gaming, “the house,” or the casinos, are detached hawkers who win every game.¹¹ However, many gambling activities and investing activities can be described equally as speculation, or the assumption of unusual, but considered, risk for the prospect of commensurate gain. Notwithstanding this reality, investing is an activity that the law supports and encourages,¹² but gambling is an activity that the law at least nominally discourages and at most prohibits.¹³

These disparate views of speculation are reflected in the regulation of these two activities. For most of the past century, gambling in the United States has been illegal by default.¹⁴ Over the past thirty years, exceptions have been drawn to legalize certain types of gambling in certain geographical areas; however, the operation of these legal gambling enterprises is subject to state regulatory control.¹⁵ Buying a passive interest in a corporation, by contrast, is legal by default. Admittedly, as the interests in a corporation become more widely disseminated and held, the corporation must fulfill various reporting and disclosure obligations and offer investment opportunities only by observing certain formalities.¹⁶ But the road to becoming a publicly-held corporation has more transaction cost barriers than legal ones.¹⁷

the securities markets is to do research and ask questions.”).

¹⁰ See JOHN GILMORE, *LOTTO: FUN OR FOLLY?* 27-28 (2001) (quoting a seminary academic as saying, “The prevalence of gambling points to a breakdown of the Puritan ethic of work . . . [T]his ethic has been replaced by the something-for-nothing philosophy”).

¹¹ See Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 650 (1996) (“Stockbrokers play a useful function in both retail and institutional sales in transmitting accessible and customized information about a very complex financial world.”).

¹² See Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 618 (1995) (“A fundamental premise of the current regulatory scheme is that stock trading is socially beneficial.”).

¹³ See *infra* Part II.A.

¹⁴ For example, until 1976, only Nevada had legalized commercial casino gambling. JOHN LYMAN MASON & MICHAEL NELSON, *GOVERNING GAMBLING* 33 (2001).

¹⁵ NAT’L GAMBLING IMPACT STUDY COMM’N, *FINAL REPORT* 3-5 to -6 (June 18, 1999) [hereinafter “NGISC REPORT”] (comparing the “Nevada” model of treating casinos as corporate citizens and the “New Jersey” model of strictly controlling all elements of casino activity).

¹⁶ See LARRY D. SODERQUIST & THERESA A. GABALDON, *SECURITIES LAW* 28-29 (2d ed. 2004) (describing the indirect expenses of going public, such as having to comply with the Exchange Act’s periodic reporting requirements).

¹⁷ See *id.* at 28 (explaining that compensation to securities firms is the greatest expense in going public, followed by legal costs).

In comparing the regulatory environments of gambling and investing, responses to innovations that test the existing frameworks provide telling contrast. In particular, comparing the regulatory responses to both online investing and online gambling reveals interesting, and quite troubling, differences in the fundamental policies behind federal regulation of these two types of Internet speculation. As one might expect, the federal government has been quite receptive to online investing,¹⁸ but unpredictably inhospitable to online gambling.¹⁹ This fairly harsh approach to online gambling is a reversal of the federal government's delegation of gambling regulation to the states,²⁰ its receptivity to tribal gaming,²¹ and its acceptance of the recent liberalization of gambling laws in most U.S. states.²²

The fierceness of the federal government's official stance in this area is puzzling until one realizes the one factor that is at stake in traditional investing, online investing, and traditional gambling, but not at stake in Internet gambling: money. Investing creates value for U.S. corporations, powerful financial intermediaries, and the federal government through taxation of dividends and capital gains. The federal and state governments have been receptive to progressive efforts to legalize casinos, which arguably can create tax revenue and jobs.²³ Lotteries, once reviled, now promise to increase state funds available for worthy public causes such as public education.²⁴ By contrast, Internet gambling, hosted by foreign operators, not only generates zero governmental revenue and zero jobs, it also threatens traditional

¹⁸ See Laura S. Unger, SEC Comm'r, Empowering Investors in an Electronic Age, Remarks at the International Organization of Securities Commissions (IOSCO) Annual Conference (May 17, 2000), available at <http://www.sec.gov/news/speech/spch380.htm>.

¹⁹ NGISC REPORT, *supra* note 15, at 5-12 (recommending that the federal government respond to the threat of online gambling by (1) explicitly prohibiting it with no exemptions; (2) targeting for prosecution internet service providers, wireless device manufacturers, credit card providers, money transfer services, and other aiders and abettors; (3) prohibiting transfers of money to these sites; (4) prohibiting states from permitting online gambling; and (5) encouraging foreign countries not to permit these sites).

²⁰ See MASON & NELSON, *supra* note 14, at 57 (“[M]ost of American politics and policymaking concerning gambling take[] place in the states.”).

²¹ See Indian Gaming Regulatory Act of 1988, Pub. L. 100-497, 102 Stat. 2467 (codified at 25 U.S.C. 2701 (2004)) (stating that the Act's goal is “to promote tribal economic development, tribal self-sufficiency, and strong tribal government”).

²² See MASON & NELSON, *supra* note 14, at 2 (describing the proliferation of legalized gambling since 1960).

²³ See *id.* at 34 (detailing casino proponents' economic arguments of “jobs, tourism, capital investment, [and] tax revenues to state and local government”).

²⁴ Cf. R. Randall Bridwell & Frank L. Quinn, *From Mad Joy to Misfortune: The Merger of Law and Politics in the World of Gambling*, 72 MISS. L.J. 565, 679 (2002) (condemning the Georgia “Hope Scholarship,” funded by the Georgia lottery since 1993, as a wealth transfer from poor lottery players to college students).

gambling.²⁵

This Article advocates a more principled, less self-interested basis for regulation: the federal government should prohibit, regulate, leave alone, or encourage speculative activities based on the utility of the enterprise and the corresponding social cost of that activity, not on whether the lure of the activity can be harnessed for government gain. Although morality myths prevail in anti-gambling rhetoric, the abundance of legalized gambling activity in almost all states weakens the authority of those myths as governmental policy. I propose that the U.S. government abandon its efforts to prohibit Internet gambling and instead create an appropriate regulatory scheme, similar to that used for physical casinos, to ensure the integrity of Internet gambling. The federal government's loose regulation of financial speculation should inform regulators' treatment of gambling speculation. Specifically, the federal government's decision to treat online trading similarly to traditional trading provides a model for treating Internet gambling similarly to traditional gambling.

This Article begins in Part I by continuing the tradition of examining the similarities of certain gambling activities and investment activities. One element of my comparison is to banish the binary model of enterprises of skill and games of chance. Adding to this body of scholarship, this Part presents a model spectrum, with categories of activities ranging from entertainment to speculation to active ownership. After comparing similar activities according to each one's utility and social costs, this Article will then compare how the United States regulates both industries in Part II. Part III explores the ensuing question of why similar speculative activities along the spectrum are regulated differently. In Part IV, attention turns to the participants in these speculative activities to determine whether characteristics of either gamblers or investors should result in categorically different legal treatment. In Part V, this Article examines the U.S. government's incongruous position with respect to online investing, in which its stated concerns for reckless retail investors are quite muted, and online gambling, in which its stated concerns for reckless gamblers are passionate and inconsistent with current policy. Part VI explores the government's full commitment to combating online gambling. This Article explores ways to harmonize the different approaches to speculation in Part VII and concludes that the government's stance against Internet gambling is misguided, its arguments for prohibition are pretextual, and its myopia on this topic is damaging its credibility in the international arena.

²⁵ See Ryan D. Hammer, *Does Internet Gambling Strengthen the U.S. Economy? Don't Bet on It*, 54 FED. COMM. L.J. 103, 118-19 (2001) (arguing that online gambling cannibalizes casino revenue and decreases state income).

I. THE SPECTRUM OF SPECULATION

A. *Model: From Entertainment to Wagering to Ownership*

Any attempt to substantively distinguish all types of gambling (from slot machines to poker to sports betting) from all types of investing (from long-term ownership to day trading to purchasing derivatives) is illusory.²⁶ These activities vary in their similarity with one another, but the universes of investing and gambling overlap greatly.²⁷ Even during the late nineteenth and early twentieth centuries, drawing a line between immoral gambling and industrious investing was difficult. As capitalism flourished, many Americans, especially those in agrarian communities, were skeptical that passive investment in the activities of others for profit differed much from gambling.²⁸ Furthermore, in an age of bucket shops, the confidence man selling dubious

²⁶ See Hazen, *supra* note 4, at 403-04 (“The illegality of, and law’s disdain for, gambling has moral overtones which makes it difficult to draw the line between bona fide market transactions and a wager.”). The line is so close, in fact, that a recent bill to prohibit online gambling included an exception for the purchase of securities, derivatives, and insurance products. Unlawful Internet Gambling Funding Prohibition Act, S. 627, 108th Cong. § 5361(1) (2003). The Act defines “bet or wager” to exclude

(i) any activity governed by the securities laws . . . for the purchase or sale of securities . . . ; (ii) any transaction conducted on or subject to the rules of a registered entity or exempt board of trade pursuant to the Commodity Exchange Act; (iii) any over-the-counter derivative instrument; (iv) any other transaction that (I) is excluded or exempt from regulation under the Commodity Exchange Act; or (II) is exempt from State gaming or bucket shop laws under section 12(e) of the Commodity Exchange Act or section 28(a) of the Securities Exchange Act of 1934; (v) any contract of indemnity or guarantee; (vi) any contract for insurance; (vii) any deposit or other transaction with an insured institution.

²⁷ For example, Cantor Fitzgerald, L.P., the financial services firm, owns Cantor Index Limited, a U.K. subsidiary offering “online, real-time financial spread betting on stock indices, equities, currencies, commodities, and bond futures” as well as “fixed-odds sports betting.” Hoover’s Fact Sheet for Cantor Index Limited, http://www.hoovers.com/cantor-index/--ID__102439--/free-co-factsheet.xhtml (last visited Mar. 17, 2006). Cantor Fitzgerald is also affiliated with Cantor G&W (Nevada), L.P., a firm engaged in gaming activities, particularly wireless gaming activities, in Delaware. Howard Stutz, *Gambling: Give Yourself a Hand*, LAS VEGAS REV.-J., Nov. 28, 2005, at D1. On September 29, 2005, Cantor Fitzgerald launched Cantor Casino, an offshore online casino that guarantees not to accept customers from the United States. Press Release, Cantor Fitzgerald, Cantor Fitzgerald Launches Cantor Casino and Cantor Gaming (Sept. 29, 2005), available at <http://www.prnewswire.co.uk/cgi/news/release?id=154960>.

²⁸ See ANN FABIAN, CARD SHARPS AND BUCKET SHOPS: GAMBLING IN NINETEENTH-CENTURY AMERICA 154 (1999) (“And since farmers believed that wealth originated with crops in the field, those who lived off exchanges appeared to be modern incarnations of the scheming gamblers who brought nothing to market but tricks and ruses and crept away with profits to which they had no right.”); GILMORE, *supra* note 10, at 33-35 (examining sermons from nineteenth-century Protestant ministers warning that profiting from stocks was immoral).

financial products seemed very similar to the confidence man selling opportunities in games of chance.²⁹

This Part proposes a new model for assessing the qualities of various speculation activities, or activities where money is wagered in expectation of a future reward in a climate of uncertainty.³⁰ Although some have attempted to distinguish gambling from investing based on risk or the expected value of a gamble or investment, this model creates a spectrum of activity based on the element of chance involved.³¹ On one end of the chance/skill spectrum, chance exclusively controls the return of an economic wager. On the other end of the spectrum, the skill of the wagerer controls the return to a greater extent. Note that placement assumes players have perfect skill in each activity; for someone with zero knowledge of poker or stock trading, that game becomes one of chance to that player. However, even the most skilled player cannot turn a game of pure chance into a game of skill. Furthermore, at no point in the spectrum does the element of chance disappear, as even in contests of skill, the impact of chance can never be eliminated.

FIGURE 1

| Pure Chance | | | | | Skill Mixed With Chance | | | | |
|-----------------------|-------------|------------------------------|-------|----------------|------------------------------------|---------------------------|-----------------|---|--|
| “L” Games; Lottery | Blackjack | Derivatives & Day Trading | Poker | Sports Betting | Trading in Individual Stocks | Insider Sports Betting | Insider Trading | Long-Term Passive Stock Ownership | Long-Term Active Stock Ownership |
| Chance | Speculation | | | | Profiteering | | Investing | | |
| Entertainment | | | | | Utility | | | | |

²⁹ See FABIAN, *supra* note 28, at 188-89 (detailing the subtle distinction between farmers’ complaints about commodities speculators and the government’s response, which was to pass laws against “bucket shops,” – those “brokerage houses that had no real connection either to stock markets or commodities exchanges” – to legitimize honest speculators).

³⁰ Myriad types of wagers could be included along the spectrum, including contracts that shift risk, such as insurance contracts and legal contingent fee arrangements.

³¹ This distinction is not novel; laws have historically distinguished games of chance from games of skill as areas of prohibited activity. See Bridwell & Quinn, *supra* note 24, at 644-46 (comparing the “English Rule” that banned games of “pure chance” to the broader “American Rule” that banned games in which chance was the “dominant element”).

In general terms, gambling activities appear more often at the “pure chance” end of the spectrum, whereas capital ownership anchors the opposite end of the chance/skill spectrum. However, many activities defy their labels of gambling and investing and can be grouped with activities bearing the other label. The purpose of constructing this model is to have a more useful and coherent view of the entertainment value, utility, and social costs of these activities for the purpose of constructing an argument that similar speculation activities should be regulated similarly.

Note that this model does not duplicate a spectrum of decreased risk or a spectrum reflecting an increase in the expected value of a wager. For example, a bet in roulette on the color black poses less risk than many investments.³² Likewise, trading on insider information involves lower economic risk than passive ownership of stocks. This spectrum reflects the role that chance plays in the outcome of a wager or investment; in other words, the extent to which the occurrence of a random event influences the return.³³ In determining whether activities are predominated by skill or chance, courts look to factors such as whether participants can learn with experience and whether skillful players win on average more than unskilled players.³⁴

Each activity on this spectrum may provide entertainment value to the participant, positive utility to the market for that activity, and a benefit or cost to society as a whole. Generally, the entertainment value to the participant is greater to the left of the spectrum when compared to the utility of the activity and the social benefit. These characterizations of the spectrum do not hold true at all points of the spectrum, possibly because entertainment is a subjective value idiosyncratic to the wagerer. Interestingly, the gambling industry advertises itself as entertainment to give the industry credibility,³⁵ and the securities industry touts the utility of capital ownership for the same reason.³⁶

B. *Games of Pure Chance*

1. “L” Games

Anchoring one end of the chance/skill spectrum are what gambling professionals call “L” games;³⁷ statistically, if you play these games long

³² Note, however, that this bet is not an even-odds bet because, depending on the roulette wheel, there is at least one possibility that is neither black nor red, but green.

³³ One definition of gambling for the purpose of gaming law contains three elements: consideration, prize, and chance. I. NELSON ROSE & MARTIN D. OWENS, *INTERNET GAMING LAW* 11 (2005).

³⁴ *Id.* at 20-21.

³⁵ See *infra* Part I.B.2.

³⁶ See *infra* Part I.E.

³⁷ See ARTHUR S. REBER, *THE NEW GAMBLER’S BIBLE* 6 (1996) (defining losing games, “Type L” games, as “those games where the house has an incontrovertible edge and where you must, in the long run, lose” and winning games, “Type W” games, as “those games

enough, you will lose. These games include lotteries,³⁸ electronic gaming devices (EGDs), and casino games such as slot machines (both mechanical and computerized), keno, video poker, baccarat, roulette, and craps.³⁹ Although players may be tempted to believe that some skill is involved, the outcome of these games is completely controlled by chance.⁴⁰ In these games, the odds favor the house; therefore, over time the house wins and the player loses.⁴¹ A player may end a playing session with a positive return on aggregate wagers, but if the player returns and continues playing, the laws of statistics will catch up with that gambler.⁴²

2. Entertainment Value, Utility, and Social Costs

Given the statistical certainty that the average player will lose at these games of chance, the economic rationality of players of these games is questionable. For some, gambling serves no useful purpose and has zero utility because, as a group, players of "L" games will put more money into the system than they will receive.⁴³ For others, any mutual exchange between individuals free to make a choice is accompanied by a mutual benefit.⁴⁴ In between these views is the argument made by casino owners and players that in these types of casino games, the utility is the entertainment value to the wagerer.⁴⁵ Instead of spending the same amount of money on a movie or a

where, with knowledge and skill, you can, in fact, win").

³⁸ See ANDREW N.S. GLAZER, *CASINO GAMBLING THE SMART WAY: HOW TO HAVE MORE FUN AND WIN MORE MONEY* 103 (1999) (arguing that "lotteries are such poor gaming risks that no casino commission would let a casino get away with running one").

³⁹ See REBER, *supra* note 37, at 43-115 (describing slots, keno, and lotteries as having the worst odds, followed by roulette, baccarat, and craps).

⁴⁰ Meir Statman, *Lottery Players/Stock Traders*, 58 *FIN. ANALYSTS J.*, Jan.-Feb. 2002, at 17-18 (giving as an example the fact that most lottery players believe that the numbers they choose have a greater chance of winning than numbers picked at random by a computer).

⁴¹ See REBER, *supra* note 37, at 12 (commenting that professional gamblers do not play Type L games but "invest" in games at which, "[a]s time goes by, they are highly confident that they are going to win").

⁴² See *id.* at 45 ("The longer you play a Type L game the more certain it becomes that you will lose and the more certain it becomes that you will lose what you are mathematically expected to lose.").

⁴³ *Id.*

⁴⁴ Cf. Stout, *supra* note 12, at 614-15 (explaining that it is the "tradition of classical economics" to equate "exchange between rational actors" with "mutual benefit and a corresponding increase in social welfare").

⁴⁵ A fourth argument is that a low-stakes, low-probability wager with a large payoff does hold a positive utility. For most people, the price of the wager is minimal and represents no change in the wagerer's standard of living. The payoff, however, does represent a positive change in standard of living. Therefore, the expected value even of an exceedingly low probability of a change in standard of living is greater than the minimal price of the wager. See Langevoort, *supra* note 11, at 636-37 (discussing how most people have a "status quo

concert, casino patrons can make a rational decision to spend the money at the casino and enjoy a stimulating session of gaming.⁴⁶

These wagers have few, if any social benefits beyond the entertainment of the player.⁴⁷ The sole utility of the wager may merely be the player's own distraction. In seeking to legalize casino gambling, however, supporters point to increased jobs and community spending, but these arguments have yet to be concretely substantiated or disproved.⁴⁸ In addition, many would argue that the social costs of these activities, including increased crime, bankruptcies, and gambling addiction, outweigh increased revenue.⁴⁹

C. *Type A Speculation: Wagers Involving Mostly Chance and Skill*

1. "W" Games

Next along the chance/skill spectrum are games of mixed skill and chance, with chance playing as important if not more important a role than skill. In the casino, these are the "W" games, meaning games at which it is possible to win consistently over time, such as blackjack and poker.⁵⁰ Notably, "W" games cost more to play at casinos than "L" games.⁵¹ In both blackjack and poker, the outcome is based in part on the odds of the next card played being a certain card or in a certain class of cards. These odds change with every card played.⁵² In blackjack, the skill involved is knowing the odds regarding the next play

bias" with regard to risk taking and are wary of high-risk investments).

⁴⁶ See REBER, *supra* note 37, at 10 (positing that a gambler may be "winning" merely by spending an enjoyable three hours playing poker and meeting fellow card players, even though the player leaves the session ten dollars down).

⁴⁷ Hazen, *supra* note 4, at 377 ("In contrast to investing, hedging and insurance, gambling is not generally viewed as a productive activity or one that provides any benefit to society beyond its entertainment value.").

⁴⁸ See Melissa Schettini Kearney, *The Economic Winners and Losers of Legalized Gambling*, 58 NAT'L TAX J. 281, 286 (2005) (referring to a study that came to a mixed conclusion regarding the net balance of positive economic effects and social costs of Native American casinos).

⁴⁹ See *id.* at 290 ("The weight of the empirical evidence suggests that casinos do in fact impose negative social costs on surrounding communities, most notably, an increased prevalence of property and violent crime.").

⁵⁰ See REBER, *supra* note 37, at 6 (explaining that as the odds in blackjack and poker fluctuate during the game, players with the greatest skill will systematically beat players with less skill).

⁵¹ Slot machines accept denominations as low as a penny, but most "W" games have minimum bet limits of \$5 to \$100 or more.

⁵² For example, if blackjack were being played with one deck, although rare at a casino, the odds of the first card in the deck being an ace would be 4 in 52. If the first card played in the deck is a king, then the odds of the second card in the deck being an ace would be 4 in 51. See REBER, *supra* note 37, at 140 (discussing wagering strategies based on the "count" at various times during play).

and playing accordingly. However, blackjack involves playing against the dealer, who is a professional participant with a high level of skill.⁵³ In addition, in the case of the tie, or a “push,” a player does not earn a return on the wager.⁵⁴

Along the chance/skill spectrum, I put poker to the right of blackjack. Arguably, the game of poker requires more skill than the game of blackjack. In blackjack, the size of the wager is determined at the beginning of the game, and so the return is predetermined. In poker, the amount of the wager increases during the game, and part of the skill is not only knowing when to continue playing and when to fold, but how much to continue betting when not folding.⁵⁵ The expected return of a poker hand changes not only with the dealt hand and the other cards played, but also with the size of the pot.⁵⁶ Poker is played against other players, not against the house, so a great deal of skill is involved in reading the other players, bluffing, and not revealing one’s strategy.⁵⁷

2. Derivatives

This category contains the types of economic investment that industry watchers might call “speculation.” These investments both are riskier and rely on chance to a greater extent than other investments, and so have the potential for large returns compared to smaller wagers.⁵⁸ Although stock trading and stock holding appear at different points in the spectrum,⁵⁹ at least two subsets of stock trading can be grouped as Type A speculation with skill-based gambling: derivatives and day trading. Therefore, in between blackjack and poker, and in the same general category, the purchasing of a derivative involves some mix of skill and chance. This category could be divided many ways because the term “derivative” encompasses a wide array of financial products in which the actual conditions of return are based on an underlying

⁵³ See I. NELSON ROSE & ROBERT A. LOEB, BLACKJACK AND THE LAW 3-4 (1998) (hypothesizing that casinos’ resentment of card counters is based on the fact that blackjack players’ winnings come from the casino while poker players’ winnings come from the other players).

⁵⁴ REBER, *supra* note 37, at 126.

⁵⁵ See *id.* at 150 (arguing that, in poker, chance affects all players equally, leaving skill as the determining factor).

⁵⁶ See *id.* at 163 (suggesting that the factors to consider in a hand are the odds of a particular hand, the amount of money in the pot, the amount of money that opponents have available for betting, and the amount of money remaining).

⁵⁷ See *id.* at 173 (explaining, for example, that “[t]ells are players’ mannerisms that signal information about their cards or their intentions”).

⁵⁸ Langevoort, *supra* note 11, at 636 (“[S]ophisticated investors at least understand that risk and return operate in tandem: the possibility of above-average return inevitably carries with it above-average risk.”); see Stout, *supra* note 12, at 708 (“[S]peculation may play a large, if not dominant, role in derivatives trading.”).

⁵⁹ See Figure 1, *supra*, Part I.A.

stock, commodity, financial benchmark, stock index, or other grouping of assets.⁶⁰ These investments incorporate an element of chance not found in ordinary stock investments: the element of time. In stock trading and buying, the investor is wagering that the stock price will increase; in derivatives, the investor is wagering that prices will rise or fall by a certain date.⁶¹ Complex derivatives based on groups of benchmarks further increase the element of chance by attracting wagers that certain benchmarks will rise and fall together *and* by a certain date.⁶²

Two major types of derivatives are futures contracts and stock options. The purchase of a futures contract in an agricultural commodity may be based on no superior knowledge at all of any factor that may affect the price of that agricultural commodity. The participant may be entering into the futures contract merely as a wager on a price change.⁶³ Therefore, the return on the wager is subject to chance, but the skill involved is knowing when one's current risk position justifies the price of the wager. The purchase of an option based on the price of a publicly-traded stock, like the purchase of the underlying stock, may involve either knowledge of the company or the industry. Alternatively, the purchase may be based on a pure hunch.

Derivatives and "W" games are similar in that both are, at most, zero-sum games.⁶⁴ In either case, the wagerer receives a return on the wager or not. In a

⁶⁰ See Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling? – Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 989-90 (1992) (describing generally how stock options and futures contracts, two main categories of derivatives, operate).

⁶¹ See *id.* (explaining that options will expire in a certain amount of time if they are not exercised and that futures contracts create a delivery obligation for a specific date in the future); see also Stout, *supra* note 12, at 705:

[A] bullish trader might buy index futures, expecting stock prices to rise so that the stocks to be delivered will be worth considerably more than the futures price on the delivery date. Conversely, a bear will sell index futures, expecting she will soon be able to purchase the stocks she has agreed to deliver at a lower price.

⁶² Although all investments have a known risk, the probabilities of certain happenings increase over time. The probability of a price increase or decrease of a short-term investment is lessened as the time is shortened. For this reason, the amount of time remaining in a stock option contract affects the price of that option under the Black-Scholes model. Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 638 (1973). An analogy may be helpful. Someone flips a coin continuously. The probability that the coin will land on tails sometime in the next five minutes is greater than the probability of that event happening in the next thirty seconds.

⁶³ See Stout, *supra* note 12, at 708 ("[D]erivatives markets are likely to attract a very high portion of those optimists willing to bet they are better than the next trader at forecasting the future of industries, interest rates and national economies.").

⁶⁴ See Hazen, *supra* note 60, at 1006 (describing how for every winner in a derivative contract there must be a loser, and one cannot expect to break even in the long term once transaction costs are included). Furthermore, poker players in casinos pay a time fee, making poker a negative-sum activity.

card game, the player either wins the hand and receives the winnings, or loses the hand and the wager. If the purchaser of a call stock option wins the “bet” that the stock price would move to a certain level, then the purchaser receives winnings in the amount that the price had moved beyond the exercise price.⁶⁵ If the stock price does not reach that point, then the option is “out of the money” and the wagerer is out the price of the option or premium.⁶⁶ In a futures contract, the losing half of the contract must either make delivery or purchase a contract that will wash out the original futures contract.⁶⁷

3. Day Trading

Another candidate for this category of speculation is day trading, although former Securities and Exchange Commission (SEC) Chairman Arthur Levitt jokingly characterized most day trading as an “L” game, not a “W” game. Levitt publicly opined that day trading was more like gambling and less like speculation because speculation required some knowledge or information, and day trading did not seem to involve either.⁶⁸ Day trading is a phenomenon borne of the Internet and the technological ability to trade stocks online.⁶⁹ During the late 1990s, a great number of individuals who were not market professionals began actively trading stocks as a full-time pursuit.⁷⁰ Not all online investors are day traders; the phrase “day trader” refers to the fact that most stocks bought were sold within a day.⁷¹ This strategy relies more on chance than skill. Most intraday stock price fluctuations result from anomalies in the market, and day traders wager on the occurrence and duration of these

⁶⁵ ROBERT W. HAMILTON & RICHARD A. BOOTH, *BUSINESS BASICS FOR LAW STUDENTS: ESSENTIAL CONCEPTS AND APPLICATIONS* 411 (3d ed. 2002) (describing a call option for AOL stock with an exercise price of \$40, which will net a holder of 333 call options \$1,055,600 should the price rise to \$82).

⁶⁶ *Id.*

⁶⁷ *Id.* at 423.

⁶⁸ Arthur Levitt, *Plain Talk About On-Line Investing*, 51 ADMIN. L. REV. 1093, 1096 (1999) (“Day traders are not really speculating because traditional speculation requires some market knowledge. They are instead gambling, which does not require market knowledge.”).

⁶⁹ Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Litigation*, 97 NW. U. L. REV. 135, 154 (2002) (describing the Internet-era phenomenon of direct trading by investors via websites, without the direct guidance of an intermediary who may have advised the investors on risk or suitability).

⁷⁰ See Caroline Bradley, *Information Society Challenges to Financial Regulation*, 37 TOLEDO L. REV. 307, 320 (2006) (commenting that although day traders considered trading their full-time job, they were not “classic professional market participants”).

⁷¹ Caroline Bradley, *Disorderly Conduct: Day Traders and the Ideology of “Fair and Orderly Markets”*, 26 J. CORP. L. 63, 63 n.2 (2000) (“The New York Stock Exchange (NYSE) has suggested that the term ‘day trading’ should be understood to refer to ‘the purchase and sale of the same security in the same day in a margin account.’”) (citing Press Release, NYSE, NYSE and NASD Propose Higher Level of Margin Requirements for Day Trading (December 10, 1999), available at <http://www.nyse.com/press/press.html>).

anomalies.⁷² Depending on the amount of skill used by the day trader, this trading philosophy may seem like a “W” game or an “L” game; most likely it is an “L” game that looks like a “W” game.

4. Utility

Involved in each of these speculative activities is some degree of entertainment, and possibly some degree of utility. Obviously, many card players enjoy playing the games, and some enjoy the games more when the wagers are high.⁷³ Some investors also experience the same type of entertainment in making risky bets via derivatives purchases or day trading.⁷⁴

Although card playing does not seem to have much utility beyond being a part of the entertainment industry, financial speculation, when engaged in wisely, is frequently described as having a legitimate economic purpose.⁷⁵ However, use of derivatives for speculation does not create wealth; profits created in favor of one contract party represent a mere wealth transfer.⁷⁶ Most compellingly, speculation in both the stock options market and the futures market has often been defended on the grounds that investors in otherwise undiversified positions need to be able to hedge against their inherently risky positions.⁷⁷ Farmers, for example, face the need to diversify by hedging against crop prices.⁷⁸ Airlines whose profits are dependent on the price of fuel oil should be able to hedge against an increase in energy prices by entering into futures contracts.⁷⁹ Banks with long-term positions at a fixed or floating rate

⁷² See BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 24 (6th ed. 1996) (“[S]hort-run changes in stock prices cannot be predicted.”).

⁷³ See Langevoort, *supra* note 11, at 637 (describing the “visceral thrill to placing a high payoff bet”).

⁷⁴ The Connecticut Council on Problem Gambling has published a quiz to determine whether an investor has a problem gambling in the stock market. One question asks whether the investor has experienced “extreme highs” or “extreme lows” when trading. Connecticut Council on Problem Gambling, Investing and Gambling Problems, http://www.ccp.org/financial/investing_gambling_problems.asp (last visited Feb. 13, 2006).

⁷⁵ See Hazen, *supra* note 60, at 1007 (summarizing three benefits of commodity derivatives: “(1) risk allocation; (2) price discovery – which results in more accurate pricing of the underlying commodity; and (3) a more accessible source of pricing information”); see also Stout, *supra* note 12, at 706 (repeating the view that if derivatives are used mainly for hedging, and not for speculating, then they can be “mutually beneficial”).

⁷⁶ Hazen, *supra* note 60, at 1006-07.

⁷⁷ See *id.* at 1007 (“Allocating risk to others thus permits externalizing the risks which these entities are less efficient at controlling.”).

⁷⁸ See *id.* at 1019 (stating that utility arguments for derivatives are stronger for physical commodities markets “because speculators provide liquidity for farmers, elevators, producers, and suppliers who want to hedge”).

⁷⁹ See Micheline Maynard, *Surging Fuel Prices Catch Most Airlines Unprepared, Adding to the Industry’s Gloom*, N.Y. TIMES, Apr. 26, 2005, at C2 (comparing airlines that

of interest may need to hedge against inflation risk with a swap derivative.⁸⁰ These types of hedges based on a countervailing financial position provide useful vehicles for shifting risk. However, some derivatives holders are not hedging risky positions but are mere speculators. Participants in these underlying markets argue that the presence of nonparticipant speculators in the futures markets lead to volatility in pricing;⁸¹ others argue that these “speculators” are necessary to provide liquidity to the market.⁸² If all ranchers need to hedge against a drop in cattle futures, then someone, a non-rancher presumably, must necessarily take that bet, or agree to the other side of the futures contract.

Similarly, day trading also has debatable utility. Because these traders have an illusion of control in their activity, they may not realize that the average day trader does not beat the market.⁸³ When the high transaction costs of active trading are included, day trading becomes a negative-sum game in which the average trader loses money.⁸⁴ Day trading attracts those who believe that they can better trade their portfolio than a market professional, and this overconfident group tends to ignore market realities.⁸⁵ Commentators argue that day traders create liquidity in the market.⁸⁶ However, others argue that

did not use futures contracts in crude petroleum to hedge against budgeted estimates of jet fuel prices with the few that did, such as Southwest Airlines, a “shining example of how to hedge fuel”).

⁸⁰ See WILLIAM W. BRATTON, *CORPORATE FINANCE: CASES AND MATERIALS* 129-31 (5th ed. 2003) (describing the mechanics of interest rate swaps).

⁸¹ See FABIAN, *supra* note 28, at 171-73 (recounting how, as early as the late nineteenth century, agricultural producers criticized speculators who purchased derivative wagers on the grounds that that agricultural prices would decline and argued that bearish speculation fulfilled prophecies by driving prices down, thus injuring producers). This argument continues today, as producers in underlying commodities complain that pure speculators artificially inflate or deflate prices away from a supply/demand equilibrium. Recently, Peter Huntsman, president of Huntsman Corporation, has been very outspoken about his view that natural gas futures speculators, including hedge funds, use a market of physical commodities to gamble on paper. See Simon Romero, *Natural Gas Inquiry Finds Price Wasn't Manipulated*, N.Y. TIMES, Aug. 31, 2004, at C2 (“The way the system is set up, big hedge funds benefit from price volatility while manufacturers are getting slammed.”).

⁸² NYMEX *NatGas Price Leads to Questions About “Speculators”*, 32 SEC. WEEK, Jan. 3, 2005, at 11 (reporting that some “industry participants” in the natural gas futures market argue that speculators play a necessary role by effectively underwriting producers’ risk).

⁸³ See Statman, *supra* note 40, at 16-17 (citing the North American Securities Administration Association for the statistic that in the 1999 bear market, 70 percent of day traders lost money).

⁸⁴ See A. Levitt, *supra* note 68, at 1096 (citing a study that found that all but one trader out of sixty-eight at a day trading firm had lost money); see also Langevoort, *supra* note 69, at 147 (pointing out that active trading lags behind passive investing because of transaction costs).

⁸⁵ Langevoort, *supra* note 69, at 147.

⁸⁶ See Stout, *supra* note 12, at 683.

day traders add to inefficiencies in the market and exacerbate irrational trends.⁸⁷ Supporters of the efficient market hypothesis argue that market professionals, or “smart money,” will capitalize on market inefficiencies and move the market back to equilibrium. Critics of this approach, on the other hand, theorize that arbitrageurs act as poker professionals, sensing that a player overvalues his hand and upping the ante or buying with the herd, thereby forcing more amateurs to lose more money into the system before the market reverts to equilibrium.⁸⁸

Opponents of gambling generally refer to social costs of problem gamblers.⁸⁹ Tellingly, these costs are also predictable with problem speculators such as day traders. As discussed later,⁹⁰ each type of speculation has a cautionary tale about how poker, derivatives, or day trading ruined someone’s life.

D. *Type B Speculation: Wagers Involving Some Chance/Some Skill*

On this spectrum of chance,⁹¹ sports betting is grouped with trading in individual stocks. Both are passive wagers on the future actions of others. Here, I make a distinction between stock trading and stock holding. Although traders may make informed trades, their ultimate goal is quick profits in a relatively short time horizon. Choosing these stocks and knowing when to sell does take skill, and the most skillful should realize more profits than the unskillful. However, the stock price is subject to elements outside of the investor’s control: the decisions of management, trends in the industry, and the overall market economy. The stock price may change based on either factors specific to that company, that industry, or the market as a whole. Similarly, gamblers that bet on individual sports games, like football, basketball, or baseball, may make informed bets based on the information available on the teams and players involved. Like the wide availability of information on publicly-held corporations, the access to information on sports teams and players is remarkable.⁹² Notwithstanding the strength of the players in a sports game, the final outcome of the game is easily impacted by elements beyond the gambler’s or the players’ control, such as injuries, lucky plays, and the mood of the crowd.

⁸⁷ See Bradley, *supra* note 71, at 86-87 (describing day trading as threatening the “orderliness” of the market).

⁸⁸ See Langevoort, *supra* note 69, at 148 (discussing the theory of “smart money” forces, as well as countervailing forces that prevent effective arbitrage).

⁸⁹ See *infra* Part V.B.1.

⁹⁰ See *infra* Part III.A.

⁹¹ See Figure 1, *supra*, Part I.A.

⁹² See DAVIES & ABRAM, *supra* note 1, at 4 (ascribing the growth in sports betting in the latter half of the twentieth century to the advent of television and the expansion of cable television programming, and more recently, to radio talk shows and the Internet).

1. Sports Betting

Like poker, in both sports betting and stock trading, there is no “house.” Sports betting is conducted through a bookmaker, who can either make odds or create a point spread on an individual sporting event.⁹³ Most sports bookies create a point spread, or a “line.”⁹⁴ This line is expressed by the bookie predicting a winner, plus a number of points, such as “Green Bay Packers by 3.”⁹⁵ A gambler cannot merely bet that the Packers will win, but must either choose to bet that the Packers (i) will win by at least three points or (ii) will either lose or win by less than three points. Conventional wisdom says that the bookmaker sets this line so that the number of bets on one side of the line will be the same as the number of bets on the other side of line.⁹⁶ The bookie profits by retaining the “juice” or “vig” for “vigorish,”⁹⁷ which is usually ten percent of each bet.⁹⁸ If the bookie is setting the line at equilibrium, then the bookie makes money whether bettors win or lose.⁹⁹ Most lines are set a few days before the game and may change slightly as bets are placed.¹⁰⁰ The line that formed the bettor’s bet continues to be that bettor’s line on game day.¹⁰¹ Surprisingly, one economist has used empirical data to challenge this assumption and has claimed that gamblers make their own gambles with the

⁹³ REBER, *supra* note 37, at 277.

⁹⁴ *See id.* at 275 (commenting that the “bookie” that sets the line may in fact be a group of experts and consultants).

⁹⁵ *See id.* at 277 (explaining that the point spread “represents the number of points that one team is favored over the other”).

⁹⁶ DAVIES & ABRAM, *supra* note 1, at 169 (“Book managers do not like to have money ‘in play’”); REBER, *supra* note 37, at 276 (“[T]he ultimate goal is to establish a line that will attract approximately half of the action to each side of the wager . . .”).

⁹⁷ REBER, *supra* note 37, at 275.

⁹⁸ *See, e.g.,* Christopher P. Liss, Beating the Book, http://www.coverwire.com/gambling_book.htm; Gambling Terms, <http://www.mcasports.com/gamblingterms.htm> (last visited Mar. 25, 2006); Sportsbook Definitions, http://www.offshore-sportsbook-casino.net/offshore-sportsbook_definitions.htm (last visited Mar. 25, 2006).

⁹⁹ DAVIES & ABRAM, *supra* note 1, at 169 (“Essentially the manager is seeking to ‘split’ the monies bet on an event to guarantee that he will make a profit no matter the outcome of the contest.”); *see* REBER, *supra* note 37, at 276 (“In sports betting . . . the line and/or odds are set by people who are deeply knowledgeable about the sport, and they are very tough to beat.”).

¹⁰⁰ Steven D. Levitt, *How Do Markets Function? An Empirical Analysis of Gambling on the National Football League* 1 n.2 (Nat’l Bureau of Econ. Research, Working Paper No. 9422, 2002) (noting that in his sample set of 20,000 sports bets placed by 285 bettors over an NFL season, the line announced on Tuesday prior to a Sunday football game changed an average of 1.4 times and that in the vast majority of those situations, the price moved by one-half of one point).

¹⁰¹ REBER, *supra* note 37, at 276.

line, taking advantage of asymmetries in skill and information in the market.¹⁰² Ironically, because sports gambling is generally illegal outside Nevada, smaller, illegal markets create more asymmetry and allow for more speculation by the bookmaker in these markets.¹⁰³

If the bookmaker's line is set at equilibrium, investors as a group will recover less than half of accumulated wagers, after taking into account the bookie's juice,¹⁰⁴ making sports betting also a negative-sum game.

2. Stock Trading

Likewise, most retail investors trade stock through a market maker, who creates a bid/ask price and moves the price so that there are an equal number of people who want to sell a stock and who want to buy a stock.¹⁰⁵ The market maker, or specialist, has a bid price and an ask price. The bid price is the price at which the market maker is willing to buy the stock and the ask price is the price he will sell the stock for. There is usually a small difference between the two prices.¹⁰⁶ As more people want to sell to the market maker, or as more people bet that the price is going to go down from a given bid price, the market maker will have a glut in that stock, and so will adjust the bid and the asking price to create demand on the "ask" side, to attract investors who will bet that the price will rise from the asking price.¹⁰⁷ The "spread" here is the same as the bookmaker's juice, although proportionately much smaller to the investment. The investor who buys stock, or who bets that the price of a stock will rise, pays not only the market maker's spread, but also a commission to the broker who placed the bid.

The bid/ask price is the equilibrium price that produces the same number of buyers as sellers of a security. However, in the securities field this price is said to reflect the homogenous expectation of all investors as to the fundamental value of a fractional share of that company, given all publicly known information.¹⁰⁸ This assumption, based on the Efficient Capital Market

¹⁰² Levitt, *supra* note 100, at 27 (concluding that bookmakers do not set the line at equilibrium but instead exploit their greater talent for predicting the outcome of games and that they take great stakes in the outcome of games). *But see* Vernón, *supra* note 3, at 6 (surmising that the point spread is unbiased in legal sports markets as opposed to illegal sports markets, such as the online sportsbook scenario that Levitt studied).

¹⁰³ *See* REBER, *supra* note 37, at 288 (commenting that the line is likely to be different in the hometowns of the two competing teams).

¹⁰⁴ *See* Vernón, *supra* note 3, at 4-6 (explaining that the breakeven point for the bookmaker is 47.6% / 52.4% because of the commission).

¹⁰⁵ WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATIONS AND FINANCE* 403 (9th ed. 2004) (detailing the different approaches taken by dealers' markets and auction markets to handling buy and sell orders).

¹⁰⁶ *See id.* at 401 (mentioning that electronic developments like Instinet allow investors to avoid paying the spread).

¹⁰⁷ *Id.* at 403.

¹⁰⁸ *See* Hazen, *supra* note 60, at 987:

Hypothesis, seems to be a legal fiction, although one that is frequently debated.¹⁰⁹ In gambling parlance, the price is merely the line at which the market maker has as many up bets as down bets.

3. Utility

Both sports betting and stock trading have some degree of entertainment value.¹¹⁰ Although the utility of sports betting may be limited, many believe that the ubiquitous availability of sports wagering drives the professional sports industries. Instead of the public's passion for competitive sports driving a complementary market in sports betting, the gambling industry may create a paying audience for professional sports. This dynamic is most clearly seen in the rise of "Fantasy Sports" leagues and the corresponding increased demand for television sports programming.¹¹¹

The utility of stock trading is similar in type to, although arguably more defensible than, the utility of day trading. The conventional wisdom has always been that stock trading has a positive social benefit, but others disagree, pointing out that active stock trading is still a zero-sum game, or negative-sum with transaction costs, even if passive stock holding is not.¹¹² Although stock holders, or "value investors," can expect a long-term profit over time, the active traders do not beat market returns over time after trading costs are considered.¹¹³ Moreover, overall trading returns decrease with increases in

According to the hypothesis, the market establishes and maintains stock prices at a level that bears a rational relationship to the "true value" of a publicly traded company, because the price reflects the total mix of information available and accounts for the views of the various sectors of the investor community.

¹⁰⁹ See *id.* at 988 ("Considerable debate continues as to whether the Efficient Capital Market Hypothesis accurately reflects market behavior, and whether it is a valid premise upon which to base regulation.").

¹¹⁰ Hazen, *supra* note 4, at 401 (commenting that the stock market is a form of entertainment for some investors); see Vernón, *supra* note 3, at 1 (hypothesizing that gamblers are not indifferent as to equal sports betting gambles but instead would pay an entertainment premium to bet on particular teams).

¹¹¹ See Chris Ballard, *Fantasy World*, SPORTS ILLUSTRATED, June 21, 2004, at 80 (giving ESPN as an example of a sports industry participant that greatly benefits from the existence of fantasy sports leagues).

¹¹² Statman, *supra* note 40, at 14 ("The stock-trading game . . . is a negative-sum game. In the absence of trading costs, management fees, and expenses, stock traders can expect to match the returns of an index of all stocks. But after trading costs are considered, they can expect to lag that index."); see Stout, *supra* note 12, at 622 (pointing out that every stock seller will either lose or benefit in an inverse proportion to the amount that the buyer will lose or benefit).

¹¹³ HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 132 (2000) (citing a six-year study of 60,000 active traders and finding that even though the traders "beat the market" by 60 basis points, their trading costs were equivalent to 240 basis points, leaving them at a loss).

trading.¹¹⁴ Although many argue that increased participation in stock trading increases the amount of capital available to corporations,¹¹⁵ money exchanged in the secondary market does not go to issuers, only to sellers of stock.¹¹⁶ Only the purchase price of stock in public offerings go to the issuer, and most issuers have only one public offering of stock. Trading occurs in the secondary market, so increasing corporate capital cannot be seen as a direct public benefit of stock trading.¹¹⁷

In addition, similar to day trading, stock trading may also create inefficiencies in the stock market. Investors' false beliefs that they can beat the market may lead them to erroneously value certain stocks, creating false price signals and causing them to invest more or less than they would otherwise.¹¹⁸ Therefore, not only will capital be misdirected into acquisition and transaction costs of active trading, but capital will also be misdirected into certain stocks.¹¹⁹

The existence of the secondary trading market seems to serve only the purpose of allowing a few investors, mostly professional investors, to profit consistently, much like sports betting or even poker. Another group that benefits from stock trading is the securities intermediaries, the brokers and market makers who receive a commission on every trade, not on every dollar of profit.¹²⁰ Therefore, these intermediaries tout active trading strategies, even

¹¹⁴ See *id.* (repeating the study's findings that the most active traders underperformed the market by 500 basis points).

¹¹⁵ See Stout, *supra* note 12, 685 (arguing that if the primary purpose of the secondary markets is to provide liquidity in order to encourage capital investment, then the secondary market could disappear altogether, because "the annual costs of secondary market trading likely equal or exceed the total amount of capital that firms raise from new issues in the first place").

¹¹⁶ See Hazen, *supra* note 4, at 386 ("All of the proceeds from these secondary sales, after applicable commissions to the securities brokers handling the transaction, go to the investors who are parting with their securities. None of these proceeds from secondary transactions in the securities markets flow back to the issuers.").

¹¹⁷ See Stout, *supra* note 12, at 685 (pointing out that investors, not issuers, benefit from the secondary markets). However, the existence of a secondary market attracts capital to issuers. Many original investors, such as venture capital firms, would not agree to fund a new company without the possibility of an IPO at some future date that would allow venture capital firms to sell their shares at a profit. The securities market allows investors to get their capital out of the corporation without harming the corporation's bottom line. ROBERT W. HAMILTON & RICHARD BOOTH, CORPORATE FINANCE: CASES AND MATERIALS 183 (3d ed. 2001) ("The existence of a market permits insiders to cash out some or all of their investment and diversify.").

¹¹⁸ See Stout, *supra* note 12, at 680-81 (discussing whether stock pricing distortions lead to serious problems).

¹¹⁹ *Id.* at 681-82.

¹²⁰ *Id.* at 642 ("Brokers are paid a commission on every stock transaction they execute, profiting from trades regardless of whether the trading investor profits.").

though they themselves are the primary beneficiaries.¹²¹ The utility of the secondary stock trading market, and the sports betting market, seems to be to allow professional bettors to profit at the expense of amateurs. The argument that trading provides liquidity in the market¹²² becomes a euphemism for the need to have a sucker on one side of every bet. The costs involved in maintaining a secondary securities market and, on an individual level, maintaining actively traded portfolios, may be seen as a welfare cost if the benefits on average are negative for the average investor.¹²³

Perhaps the SEC encourages retail investing for the same reason that casinos encourage amateur gamblers to participate. A truly efficient stock market would not produce large profits for any investor. However, reckless investors provide arbitrage opportunities for professional investors. Without reckless investors, the profits to be made in the capital markets would be much smaller. In addition, the financial services industry makes money on every trade through a paid commission, whether the trade is foolish, inspired, or informed.

E. *Ownership: Wagers Involving Mostly Skill/Some Chance*

To the right of the spectrum are activities that require less explanation. These are activities that involve individuals making capital investments of their money, property, or labor in the hopes of realizing a return on that investment in the future. As noted previously, no amount of skill contributed to these skill-based activities can eliminate the element of chance. First are passive, but long-term ownership investments, either in publicly-held corporations or in other business organizations. At the end of the spectrum¹²⁴ are activities where the investor is an active participant in managing the enterprise, thus requiring more skill and knowledge of the enterprise. These activities could include anything from formal economic activity such as starting a business to informal economic activity such as investing tuition and labor in the acquisition of a law degree. The degree of risk will vary greatly with the type of enterprise, but the utility should be self-evident: the provision of capital for the creation of products and services.

F. *Inside Bets: Insider Sports Betting and Insider Trading*

Although a thorough discussion of the utility of both insider sports trading and insider securities trading is beyond the scope of this paper, the location of these activities on the spectrum is worth noting. Although these activities involve less financial risk than other activities, they are regulated more closely than most activities at the right end of the spectrum. Most sports leagues ban

¹²¹ See *id.* at 642 (hypothesizing that brokers may knowingly or unknowingly steer clients into perceived new opportunities when the clients should adopt a long-term holding strategy).

¹²² See *id.* at 623 (criticizing the liquidity argument for stock trading as “weak”).

¹²³ See *id.* at 677.

¹²⁴ See Figure 1, *supra*, Part I.A.

gambling on their sport by players, whether or not a gambler wagers on the gambler's own team.¹²⁵ In the securities industries, corporate insiders may trade stock in their own companies, and in fact are encouraged to do so. These employees may in fact receive stock, options, appreciation rights, or other derivatives of the company's stock as part of their compensation.¹²⁶ However, insiders or their tippees may not trade on material, nonpublic information, and certain insiders must make a filing with the SEC describing any trade after the trade is executed.¹²⁷

II. REGULATION OF SPECULATION ACTIVITIES IN THE UNITED STATES

Many commentators have reasoned that the flourishing of many types of gambling in the colonial United States and then on the Western frontier was a result of the entrepreneurial character of those who settled the United States.¹²⁸ The risk-seeking, prospector mentality fueled not only Western expansion, but the growth of both the stock exchanges and gambling.¹²⁹ Historian John Findlay described the American people as "a people of chance," and this character trait both helped to grow the economy and found an outlet in gambling.¹³⁰ Given this shared origin, the division of these two types of speculation into one that was morally just and one that was morally troubling is in itself dubious and disconcerting.¹³¹

¹²⁵ See DAVIES & ABRAM, *supra* note 1, at 148-52 (describing the rise and fall of Pete Rose, widely thought to have broken major league baseball's "ironclad ban prohibiting gambling on baseball," a rule put in place after the 1919 Black Sox scandal). Besides attempting to keep scandals out of the league, antigambling rules may also be paternalistically designed to protect young people unaccustomed to sudden wealth. See *id.* at 147-48 (retelling the heartbreaking story of All-American Art Schlichter, whose promise as an NFL first-round draft pick was destroyed by his compulsive gambling addiction).

¹²⁶ See generally Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002).

¹²⁷ SODERQUIST & GALBADON, *supra* note 16, at 143 (describing the application of Rule 10b-5 to insiders who disclose "material, nonpublic information to another party, who then trade[] securities based on the information").

¹²⁸ See JOHN FINDLAY, *PEOPLE OF CHANCE* 4 (1986).

¹²⁹ See THOMAS BARKER & MARJIE BRITZ, *JOKERS WILD: LEGALIZED GAMBLING IN THE TWENTY-FIRST CENTURY* 21-22 (2000) ("In the early nineteenth century new gambling forms appeared among the wealthy and merchant classes – stockjobbers (stockbrokers) and land speculators.").

¹³⁰ See generally FINDLAY, *supra* note 128, at 4 (1986) (chronicling the Western expansion of the United States and the risk-seeking nature of the people that settled California and the other Western states).

¹³¹ See FABIAN, *supra* note 28, at 6-7 ("Although they attacked gambling, reformers recognized that profits on the stock markets were often the results of lucky gambles and that it was difficult to assert a vast moral difference between stock markets and gambling casinos.").

A. *Historical Background of Gambling Regulation*

1. *Gambling Before 1931*

The United States has a complex history of regulating gambling activity. In the eighteenth and nineteenth centuries, gambling was fairly widespread, including card games,¹³² racetracks,¹³³ and particularly lotteries, as colonists imported this popular money-raising device from Europe.¹³⁴ Accumulating capital for public purposes was difficult for state and municipal governments before the institution of standard taxation regimes.¹³⁵ Raising capital for long-term projects was also difficult for private enterprises before the emergence of the banking industry and the modern corporation, with the ability to lock in shareholder capital indefinitely and offer shareholders limited liability in return.¹³⁶ The lottery filled this void and allowed the government and private parties who petitioned the government to use lotteries to raise capital for public goods. Lotteries were used as modern-day bond offerings, with private brokers launching raffle-style lotteries for the purpose of attracting monies for large-scale endeavors such as public infrastructure and private construction projects.¹³⁷ The states did not run these lotteries, but authorized private groups to conduct them.¹³⁸ For example, monetary support for colonial troops during the Revolutionary War was collected through a lottery, as was money to improve the Erie Canal¹³⁹ and to build roads in various states.¹⁴⁰ Lotteries

¹³² See BARKER & BRITZ, *supra* note 129, at 24 (commenting that card games were most popular in the Western states and providing as an example the card club run by Wyatt Earp and Doc Holliday in Tombstone, Arizona).

¹³³ See William A. Taggart & Jacqueline Wilks, *Gambling in the American States: "Finding Some Action" Has Never Been Easier*, 9 GAMING L. REV. 3, 3 (2005).

¹³⁴ See Gerald Willmann, *The History of Lotteries* 12 (Aug. 3, 1999) (unpublished manuscript), available at <http://willmann.bwl.uni-kiel.de/~gerald/history.pdf> (describing the first lottery in the New World as the 1746 lottery in New York to finance fortification of the city). In fact, a lottery conducted in England helped to fund the Virginia Company. The Jamestown colony was also funded by a lottery conducted in London by King James I. FINDLAY, *supra* note 128, at 11-14.

¹³⁵ BARKER & BRITZ, *supra* note 129, at 20. The Sixteenth Amendment, which empowered the United States government to impose an income tax, was not ratified until February 13, 1913. Modern lotteries are often described as ways to generate state revenue without raising taxes. *Id.* at 78.

¹³⁶ See Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 387-89, 389 n.3 (2003) (noting that by 1800, only 335 corporations had been chartered in the United States, and not all states offered limited liability to those incorporated in their state).

¹³⁷ See MASON & NELSON, *supra* note 14, at 8 (discussing the use of lotteries in all thirteen colonies to fund worthy causes).

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ See, e.g., *Phalen v. Virginia*, 49 U.S. 163, 167 (1850) (describing the lottery

financed buildings at Harvard, Yale, Columbia, Dartmouth, and Williams, as well as lighthouses and jails.¹⁴¹ Religious groups frequently used lotteries to raise money for new buildings.¹⁴² Although more popular in the Southern colonies, lotteries could be found even in colonies with a strong Puritan influence, such as Massachusetts.¹⁴³ Unfortunately, private lottery companies strayed from pure public purposes in the nineteenth century, and some lotteries were found to be fraudulent.¹⁴⁴

Although the vast majority of states had prohibited lotteries prior to 1862,¹⁴⁵ either because of concerns of fraud or of the questionable morality of lotteries,¹⁴⁶ the war-torn Southern states revived the private-run lottery in an attempt to raise state revenue.¹⁴⁷ As lottery states began to sell tickets to residents of non-lottery states¹⁴⁸ through the U.S. mails and wire offices, nongambling states turned to the federal government to intervene in the state regulatory experiment on gambling. The federal government passed legislation culminating in the Federal Anti-Lottery Act in 1895,¹⁴⁹ which was upheld by the U.S. Supreme Court in 1903 as a proper exercise of federal lawmaking power under the Commerce Clause.¹⁵⁰ By 1894, every state had

conducted by the Fauquier & Alexandria Turnpike Road company for the benefit of improving three miles of the turnpike road).

¹⁴¹ GILMORE, *supra* note 10, at 114; MASON & NELSON, *supra* note 14, at 8; Willmann, *supra* note 134, at 12-13.

¹⁴² FABIAN, *supra* note 28, at 1; *see* MASON & NELSON, *supra* note 14, at 8 (commenting that the Quakers were the only Christian denomination that did not conduct a lottery during this period).

¹⁴³ DAVIES & ABRAM, *supra* note 1, at 9.

¹⁴⁴ *See* MASON & NELSON, *supra* note 14, at 8 (describing a fraudulent lottery in New York in 1818 called the "Medical Science Lottery," in which the brokers conducting the lottery provided the winning numbers in advance to wealthy individuals in the hopes of future consideration).

¹⁴⁵ *See* Jonathan Gottfried, *The Federal Framework for Internet Gambling*, 10 RICH. J.L. & TECH. 26, ¶ 6 (2004), <http://law.richmond.edu/jolt/v10i3/article26.pdf> (stating that by 1862, only two states, Missouri and Kentucky, had not prohibited lotteries).

¹⁴⁶ *See* Phalen v. Virginia, 49 U.S. 163, 168 (1850) (construing a criminal law passed in Virginia in 1834 that prohibited lotteries and explaining that "[e]xperience has shown that the common forms of gambling are comparatively innocuous when placed in contrast with the widespread pestilence of lotteries"); *see also* Willmann, *supra* note 134, at 16 (describing numerous laws prohibiting lotteries in the early 1800s as being particularly ineffective).

¹⁴⁷ MASON & NELSON, *supra* note 14, at 8.

¹⁴⁸ *See id.* (discussing the Louisiana Lottery Company, which sold ninety percent of its tickets outside Louisiana).

¹⁴⁹ Ch. 191, 28 Stat. 963 (1895) (prohibiting interstate transportation of lottery tickets).

¹⁵⁰ *Champion v. Ames*, 188 U.S. 321, 363-64 (1903) (upholding the ability of the federal government to prohibit interstate transmission of lottery tickets under the commerce clause). Note that the Federal Anti-Lottery Act was amended in the 1970s to create an exception for state-run lotteries. Gottfried, *supra* note 145, ¶ 6 (referring to 18 U.S.C. § 1307).

enacted legislation prohibiting lotteries and most other forms of gambling, although illegal lotteries continued.¹⁵¹

During the nineteenth century, morality arguments against gambling took center stage in the debate. Reformers pointed to gambling as an immoral activity engaged in by flouters of the Puritan work ethic, people who wanted to obtain something of value without contributing any work.¹⁵² Reformers also used economic prudence arguments to show that gambling was an affront to sober-minded capitalist values of savings and investment.¹⁵³

This period also saw the emergence of both the stock market and real estate speculation as widespread activities.¹⁵⁴ Regulators were forced to walk a fine line between moral speculation that was legal and immoral speculation that was not. Primarily, concerns arose surrounding “bucket shops,” small storefronts that purported to offer opportunities to purchase futures contracts on commodities.¹⁵⁵ These shops were pure speculation shops, with the owners having no offsetting obligations.¹⁵⁶ Investors could also purchase “futures” in the price of a stock without having an obligation to buy or sell the actual stock; these contracts were sometimes called “difference contracts” and were similar to betting on the price of a stock or commodity.¹⁵⁷ These shops were often fraudulent, but they also competed with the emerging commodities exchanges.¹⁵⁸ Through the Commodity Exchange Act, the federal government created a monopolistic regime whereby no futures contract would be enforceable unless it was traded on an organized exchange.¹⁵⁹ This law required futures contracts to have an obligation of delivery, distinguishing valid contracts from “difference contracts,” which were (and are) considered to be gambling.¹⁶⁰ However, virtually all futures contracts are satisfied by the purchase of an offsetting futures contract, making the distinction illusory.¹⁶¹

¹⁵¹ MASON & NELSON, *supra* note 14, at 9; *see* Taggart & Wilks, *supra* note 133, at 3 (“[B]y the early 1900s, virtually all forms of legalized gambling had disappeared from the American landscape.”).

¹⁵² BARKER & BRITZ, *supra* note 129, at 20; *see* FABIAN, *supra* note 28, at 2-3 (repeating reformers’ arguments that gamblers undermined economic stability because, like thieves and parasites, they sought profits while they produced nothing in return).

¹⁵³ *See* FABIAN, *supra* note 28, at 4-5 (arguing that by labeling gambling as immoral and irrational, gambling became a “negative analogue” that gave other forms of investment and speculation credibility).

¹⁵⁴ BARKER & BRITZ, *supra* note 129, at 21-22 (describing stockjobbing and land speculation as gambling for “the wealthy and merchant classes”).

¹⁵⁵ FABIAN, *supra* note 28, at 189.

¹⁵⁶ Hazen, *supra* note 60, at 1014.

¹⁵⁷ *Id.* at 1015.

¹⁵⁸ *Id.* at 1014.

¹⁵⁹ *Id.* at 1017.

¹⁶⁰ *See id.* at 1016-17 (“It eventually became the rule that a futures contract taking place on a bona fide contract market does not constitute illegal gambling.”)

¹⁶¹ *See id.* at 1017 (estimating that ninety percent of futures contracts are closed out with

2. Casino Games

All forms of gambling remained illegal in the United States until 1931. In the aftermath of the stock market crash of 1929 and the economic depression that followed, the state of Nevada turned to casino gambling to revitalize its economy.¹⁶² Contemporaneous with the federal government creating the SEC and passing sweeping federal laws to regain investor confidence in the stock market,¹⁶³ Nevada legalized casino gambling in 1931.¹⁶⁴ Would-be casino owners paid consideration for this boon in the form of state taxes and regulatory oversight.¹⁶⁵ For over forty years, Nevada would stand alone in the United States as the one state in which casino gambling was legal.

The modern movement to legalize casinos began in 1976 when New Jersey legalized casino gambling in Atlantic City.¹⁶⁶ Legislators in other states attempted to duplicate the same legalization, but many failed.¹⁶⁷ Some states were successful. Generally, if one state was able to legalize casino gambling, in either commercial casinos or federally regulated tribal casinos, its neighboring states would gain useful ammunition to argue for their own casinos.¹⁶⁸ A winning argument seemed to be that residents were taking their gambling money out-of-state.¹⁶⁹ States established casinos not only to keep entertainment money flowing to state businesses, but also into state coffers. The states that legalized casino gambling struck different deals with the casinos as to the level of state taxation of revenue; some states retained a modest percentage while other states retained a healthy slice of the gambling pie.¹⁷⁰

One outgrowth of legalized casino gambling has been a surge in legalization of electronic gaming devices, or EGDs,¹⁷¹ which are stand alone video games

offsetting contracts).

¹⁶² MASON & NELSON, *supra* note 14, at 29.

¹⁶³ See SODERQUIST & GALBADON, *supra* note 17, at 12 (describing the Securities Act of 1933 as the “quintessential New Deal legislation”).

¹⁶⁴ MASON & NELSON, *supra* note 14, at 29.

¹⁶⁵ See *id.* at 32-33 (describing the “Nevada model” of licensing, regulating, and taxing commercial casinos).

¹⁶⁶ *Id.* at 33 (explaining that an effort to legalize gambling statewide in New Jersey failed in 1974; the 1976 legalization applied only to Atlantic City).

¹⁶⁷ *Id.* at 34-35 (reporting that between 1978 and 1988, sixteen out of seventeen state campaigns to legalize gambling failed – some repeatedly).

¹⁶⁸ *Id.* at 36 (theorizing that the pressure to legalize casino gambling grew in states that were located near gambling states).

¹⁶⁹ See *id.* at 37-38 (describing how riverboat casinos managed to draw citizens from neighboring states, thus causing those states to “recapture” revenue by developing their own riverboat casinos).

¹⁷⁰ See Kearney, *supra* note 48, at 288 (“Maximum tax rates on gross gaming revenues in American casinos range from 6.25 percent in Nevada to 35 percent in Illinois.”).

¹⁷¹ See Bridwell & Quinn, *supra* note 24, at 578-82 (describing how South Carolina came to enact the Video Game Machines Act in 1993).

with pay out abilities. In some states, EGDs are found in non-casino establishments, such as restaurants, bars, convenience stores, and even grocery stores.¹⁷² In Las Vegas, EGDs can be found in the airport. In other states with no casino gambling, EGDs have been legalized as a less dangerous form of gambling.¹⁷³ However, many argue that EGDs, such as video poker, are the “crack cocaine” of gambling: dangerously addictive and hard to regulate.¹⁷⁴ Illegal EGDs are in operation in many states.¹⁷⁵

3. Lotteries

At the same time that states were legalizing casino gambling and the federal government was allowing tribal casino gambling, states also began to reintroduce lotteries. Unlike colonial America, states now chose to own their lotteries and not allow private concerns to have lotteries, ensuring a monopoly.¹⁷⁶ In addition, states retained all the profits, after administrative costs and prizes, for their own coffers.¹⁷⁷ In 1964, New Hampshire was the first state to re-legalize the lottery.¹⁷⁸ Currently, forty states and the District of Columbia conduct lotteries.¹⁷⁹ Some smaller states have even joined together to form larger lottery pools.¹⁸⁰ Also, some states allow playing the lottery via video lottery terminals (VLTs), which simulate a casino slot machine terminal, and some states are experimenting with selling lottery tickets over the Internet.¹⁸¹ Notably, no state that has legalized lotteries in the modern era has

¹⁷² See *id.* at 577 (stating that video gambling devices in South Carolina were in convenience stores, bars, and truck stops).

¹⁷³ See BARKER & BRITZ, *supra* note 129, at 11 (stating that gambling machines are required to have a set minimum payout, unlike other casino games); Bridwell & Quinn, *supra* note 24, at 568 (describing how a state with no other legalized gambling came to have a three billion dollar EGD industry).

¹⁷⁴ Bridwell & Quinn, *supra* note 24, at 692-93.

¹⁷⁵ See *id.* at 613 (reporting that, in the first quarter of 2001, the illegal EGD industry in North Carolina generated \$4.2 million in wagers).

¹⁷⁶ See Taggart & Wilks, *supra* note 133, at 7, 8 (reporting that, by late 2003, forty states had legal state-run lotteries).

¹⁷⁷ See *id.* at 3 (stating that, in 2002, commercial casinos in eleven states generated \$25 billion in revenue, \$4 billion of which went to the states).

¹⁷⁸ Kearney, *supra* note 48, at 291.

¹⁷⁹ *Id.*

¹⁸⁰ In 1985, the Tri-State Lotto was formed, with Maine, New Hampshire, and Vermont participating. North American Association of State and Provincial Lotteries, Lottery History, <http://www.naspl.org/history.html> (last visited Mar. 20, 2006). In 1988, Powerball was formed by the Multi-State Lottery Association, which currently includes twenty-eight states, the District of Columbia, and the U.S. Virgin Islands. Multi-State Lottery Association Home Page, <http://www.musl.com> (last visited Jan. 29, 2006).

¹⁸¹ MASON & NELSON, *supra* note 14, at 23-24 (stating that Delaware, Oregon, Rhode Island, South Dakota, and West Virginia allow VLTs even though these devices “appear to be one of the most addictive forms of gambling”); Kearney, *supra* note 48, at 293 (reporting

repealed the lottery.

4. Pari-Mutuel Betting

During the 1930s, a number of states legalized other forms of gambling, including pari-mutuel horse racing and dog racing.¹⁸² Horse races were never prohibited, but gambling on the races was illegal in many states, although illegal betting was rampant.¹⁸³ During the twentieth century, almost all states built racetracks and legalized betting on horse races and dog races to capture the benefit of tax revenue and perhaps intangible benefits to the local economy.¹⁸⁴ However, the growth of legal casino gambling and lotteries since 1976 has forced racetracks have had to compete for gambling revenue.¹⁸⁵ To do so, the federal government has allowed remote betting on horse racing and dog racing.¹⁸⁶ In addition, some states have allowed racetracks to install EGDs, simulcasts of races at other tracks, and some casino games.¹⁸⁷

5. Sports Betting

The one form of gambling that has not seen an expansion in legalization is sports betting,¹⁸⁸ although this type of gambling did experience an incredible

that California and West Virginia have recently introduced stand-alone VLTs).

¹⁸² MASON & NELSON, *supra* note 14, at 29 (asserting that in the 1930s, “more than twenty state governments legalized and taxed pari-mutuel betting on horse racing as a quest for new revenues”).

¹⁸³ The most popular illegal betting operation during this time would be the Irish Sweepstakes, which ran from 1930 until 1987 and tracked the results of popular horse races. Although this sweepstakes was run by the government of Ireland to finance hospitals, many U.S. citizens bought tickets on the black market. *See Legislation Relating to Organized Crime: Hearings on H.R. 468, H.R. 1246, H.R. 3021, H.R. 3022, H.R. 3023, H.R. 3246, H.R. 5230, H.R. 6571, H.R. 6572, H.R. 6909, H.R. 7039, Bills to Provide for New Federal Criminal Statutes, Before Subcomm. No. 5 of the H. Comm. on the Judiciary, 87th Cong. 352 (1961)* (statement of Herbert J. Miller, Jr., Criminal Division, U.S. Department of Justice) (stating that the passage of the Wire Wager Act would make it illegal for Americans to purchase tickets in the Irish Sweepstakes, a legal contest in Ireland).

¹⁸⁴ *See* Taggart & Wilks, *supra* note 133, at 4 (reporting that, by late 2003, forty-three states had legal thoroughbred gambling and forty-two states had intertrack wagering).

¹⁸⁵ MASON & NELSON, *supra* note 14, at 29-30.

¹⁸⁶ *See* Taggart & Wilks, *supra* note 133, at 4 (reporting that, by late 2003, twenty-five states allowed off-track wagering).

¹⁸⁷ MASON & NELSON, *supra* note 14, at 30.

¹⁸⁸ *See* DAVIES & ABRAM, *supra* note 1, at 2 (remarking that sports betting is one of the “largest untapped sources of potential tax revenue in the nation”). In fact, legislators frequently introduce bills in Congress to strengthen federal sports betting laws, especially sports betting on amateur sports. *See, e.g.*, Student Athlete Protection Act, H.R. 1422, 109th Cong. (2005) (proposing to prohibit high school and college sports gambling in all states, including the four states in which such gambling was permitted prior to 1991).

expansion in the last half of the twentieth century.¹⁸⁹ After the passage of the Professional and Amateur Sports Protection Act in 1992,¹⁹⁰ sports betting is legal only in those three states that operated legal sports gambling at that time: Nevada, Oregon, and Delaware.¹⁹¹ However, only Nevada currently has a vigorous legal sports betting industry, and Oregon has a more limited variety.¹⁹² Sports betting is also the one form of non-tribal gambling that has attracted the attention of the federal government. Unlike other forms of gaming, such as poker, blackjack, or slot machines, sports betting is a type of gambling that is conducive to remote participation. Participating in a casino game over the telephone is inconceivable, but placing a sports bet in the course of a telephone conversation has been practical for some time. In 1961, Congress passed the Wire Communications Act, or the “Wire Act,” in response to concerns that gamblers in states outside of Nevada were placing sports bets to Nevada bookies over the telephone.¹⁹³ The Wire Act prohibits the use of “wire communications” to place a bet or wager on a sporting event or contest.¹⁹⁴

Although exact figures for the number of illegal bets and amounts wagered are impossible to calculate, the National Gambling Impact Study Commission estimated that illegal sports betting in the United States could be a \$380 billion industry.¹⁹⁵ From March Madness office pools to Fantasy Sports to Super Bowl parties, sports betting is fairly ubiquitous in daily American life. Although generally illegal outside of Nevada, many newspapers publish the “Las Vegas line” and give details of injury reports to aid gamblers.¹⁹⁶ Of

¹⁸⁹ See DAVIES & ABRAM, *supra* note 1, at 145 (describing a 1986 *Sports Illustrated* article reporting that bookies who had once received mostly horse racing wagers now manage sports bets almost exclusively).

¹⁹⁰ Pub. L. 102-559, 106 Stat. 4227 (1992) (codified at 28 U.S.C. § 3701 (2004)).

¹⁹¹ 28 U.S.C. § 3704(a)(1).

¹⁹² Oregon Lottery – Sports Action, <http://www.oregonlottery.org/sports> (last visited Apr. 12, 2006); see Ari Weinberg, *The Case for Legal Sports Gambling*, Jan. 27, 2003, FORBES.COM, http://www.forbes.com/2003/01/27/cx_aw_0127gambling.html (explaining the operation of Oregon’s Sports Action, a weekly football lottery game).

¹⁹³ Wire Communications Act, 18 U.S.C. § 1084 (2000) (setting forth penalties for the transmission of wagering information); H.R. REP. NO. 87-967, at 1 (1961), *as reprinted in* 1961 U.S.C.C.A.N. 2631-32 (stating that modern day bookmaking was dependent on telephone service for both the making of wagers and the transmission of sports results, and that preventing the transmission of this information would suppress organized gambling activities).

¹⁹⁴ *Id.* § 1084(a):

Whoever being engaged in the business of betting or wagering knowingly uses a wire communication facility for the transmission . . . of bets or wagers . . . on any sporting event or contest . . . shall be fined under this title or imprisoned not more than two years or both.

¹⁹⁵ NGISC REPORT, *supra* note 15, at 2-14 (describing sports betting as “the most widespread and popular form of gambling in America”).

¹⁹⁶ DAVIES & ABRAM, *supra* note 1, at 146.

course, Nevada sports betting is also a large industry, attracting many amateur and professional sports gamblers during popular sporting events.¹⁹⁷

Notwithstanding the regulatory stagnation of legalized sports betting, at present, the United States has more forms of legalized gambling than in any time in over 100 years.¹⁹⁸ In light of this unprecedented wave of liberalization, the outcry of both the federal government and the state governments to the prospect of Internet gambling is both incongruous and troubling, as discussed in Part V.

B. *Current Securities Regulation Environment*

Two years after Nevada legalized casino gambling, Congress passed the first federal securities law, the Securities Act of 1933.¹⁹⁹ States had previously regulated the sales of securities under so-called “blue-sky” laws.²⁰⁰ However, the federal government’s approach to regulation of publicly-held companies was that these companies would disclose certain information to investors at certain intervals.²⁰¹ If the material proved later to have been false in a material respect, then the company could face civil and, to a lesser extent, criminal penalties.²⁰² The federal government specifically chose not to examine the merit of the underlying investment.²⁰³ Even after the most recent increases to federal regulation under the Sarbanes-Oxley Act of 2002,²⁰⁴ this form-over-substance approach remains intact. Although new disclosure requirements have increased transaction costs for offering common stock to the public and for maintaining the status of publicly-held corporations,²⁰⁵ the availability of

¹⁹⁷ See *id.* at 2-3 (mentioning tourists’ bets placed on the Super Bowl during a visit to Las Vegas).

¹⁹⁸ See Taggart & Wilks, *supra* note 133, at 4 (“For the vast majority of states, however, the tendency has been to expand, sometimes quite significantly, the permissiveness of state laws governing gambling activities.”).

¹⁹⁹ Ch. 38, 48 Stat. 74 (1933).

²⁰⁰ Hazen, *supra* note 60, at 1014 (explaining that blue-sky laws began to appear in 1911). *Black’s Law Dictionary* defines “blue-sky law” as “[a] state statute establishing standards for offering and selling securities, the purpose being to protect citizens from investing in fraudulent schemes or unsuitable companies.” BLACK’S LAW DICTIONARY 183 (8th ed. 2004).

²⁰¹ See generally CARL W. SCHNEIDER, NOW THAT YOU ARE PUBLICLY OWNED. . . (Nancy Jean Fulop Short ed., 2002) (describing the various reporting and disclosure obligations under federal securities law).

²⁰² See *id.* at 27-33 (discussing disclosure requirements generally).

²⁰³ SODERQUIST & GALBADON, *supra* note 17, at 12 (detailing how the first draft of the Securities Act reflected “merit regulation” and was rejected by President Franklin Roosevelt); Hazen, *supra* note 4, at 382 (describing that, in drafting the Securities Act, Congress “debated but rejected a merit approach to regulation that would examine the substance of the investment product being offered and sold”).

²⁰⁴ Pub. L. No. 107-204, 116 Stat. 745 (2002).

²⁰⁵ See generally Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate*

legal investing opportunities for individuals has never been greater. Besides being able to own stock in a corporation, investors are also able to purchase an almost infinite variety of options, limited only by the option writer's imagination.²⁰⁶ Also, since the passage of the Commodity Futures Modernization Act of 2000,²⁰⁷ investors can purchase over-the-counter future contracts on almost anything.²⁰⁸

C. *Historical Arguments for Distinguishing Capitalistic Speculation from Gaming Speculation*

Some commentators have argued that historical suspicion of gambling is, at best, paternalistic and, at worst, classist.²⁰⁹ Gambling has been blamed for social problems ranging from personal tragedies, such as addiction, divorce, bankruptcy, and domestic abuse, to public ills, such as crime and welfare burdens.²¹⁰ Arguments against gambling may focus on the immorality of either striving to achieve something without earning it or worshipping luck and therefore straying from monotheistic Judeo-Christian teachings.²¹¹ Other arguments focus on the added social costs,²¹² even of gambling activities that are touted as bringing revenue to the state and prosperity to the community.²¹³ State-sponsored lotteries have also been condemned for being a regressive tax

Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. CORP. L. 1 (2002).

²⁰⁶ See HAMILTON & BOOTH, *supra* note 117, at 555 (describing the many types of derivatives that can be formed in entities that hold mortgages).

²⁰⁷ Pub. L. No. 106-554, 114 Stat. 2763 (2000) (codified as amended at 7 U.S.C. § 1).

²⁰⁸ See Hazen, *supra* note 4, at 389-90 (comparing the pre-Act futures markets to gambling casinos that have a state-granted monopoly on a particular wagering product).

²⁰⁹ See, e.g., BARKER & BRITZ, *supra* note 129, at 22 (stating that gambling laws were directed at lower class activities such as public gambling and lotteries); FABIAN, *supra* note 28, at 12-13 (analyzing gambling restrictions designed to regulate the behavior of the poor while ignoring private bets among the wealthy); Hazen, *supra* note 4, at 396-97 (comparing paternalistic regulation of securities and gambling).

²¹⁰ See John D. Andrie, Note, *A Winning Hand: A Proposal for an International Regulatory Schema with Respect to the Growing Online Gambling Dilemma in the U.S.*, 37 VAND. J. TRANSNAT'L L. 1389, 1392 (2004) (estimating societal costs of all gambling to be five billion dollars a year).

²¹¹ See GILMORE, *supra* note 10, at 30 (arguing against the "contention that the only wealth worthily gained and retained is that earned by hard labour").

²¹² See Kearney, *supra* note 48, at 281 (citing a 2004 Gallup poll finding that two-thirds of Americans had gambled in the last twelve months, and a 2003 Gallup poll finding that fifty percent of Americans had bought a lottery ticket in the last twelve months).

²¹³ See *id.* at 286-87 (citing a 2004 study that estimated the net cost of a casino as seventy-five dollars per adult resident). Although pro-gambling legislators tout additional tax revenue from lotteries and casinos, empirical evidence so far does not show economic growth from some casinos, such as riverboat casinos frequented by daytrippers who do not patronize local businesses. *Id.* at 286. In addition, state lotteries and casinos may cannibalize revenue from each other and from other local entertainment options. *Id.*

because taxpayers in lower tax brackets “pay” a proportionately higher tax, even though taxpayers in different income groups gamble an equal amount of money.²¹⁴ Although research shows that lottery ticket buyers represent all “races, sexes, and income and education groups,” that research does show differences in the types of lottery products that residents of lower-income, middle-income, and higher-income zip codes purchase.²¹⁵

However, disdain for gambling may also be less civic-minded. Gambling threatens social order; in the throw of the dice, a commoner can become a wealthy citizen,²¹⁶ a slave a freedman.²¹⁷ Gambling is anathema to the Puritan work ethic, but it also violates unspoken values of knowing one’s place and living within one’s class. In addition, historically, financial speculation was engaged in by the elite; therefore, it was respectable. Gaming speculation, especially as engaged in by the poorer classes, was frowned upon and at times prohibited.²¹⁸ In fact, the first anti-gaming statute in England applied only to a “servant of husbandry, . . . labourer, . . . servant, . . . artificer, . . . [or] victualler.”²¹⁹ Horse racing provides another example of classist regulation. Historically, trackside wagering was a legal activity for the wealthy who could afford entry fees; however, off-track betting on the same race in the same town by the working classes was illegal.²²⁰

Moralistic arguments against gambling may also have been spurred by proponents of the nascent banking and securities industry. As disposable income was scarce, gambling competed with other speculation activities, such as savings and investments.²²¹ Historians have theorized that powerful individuals may have wanted to protect the financial arenas that they controlled.²²²

²¹⁴ See *id.* at 292-93 (finding that “state lottery products are disproportionately consumed by the poor”).

²¹⁵ *Id.* at 292 (asserting that average annual lottery spending is roughly equal among socioeconomic groups but that low-income lottery players focus on instant games with worse odds than jackpot lotteries, making lotteries more regressive than previously thought). Lottery opponents also argue that African-Americans gamble away more money in lotteries than other Americans. In 1998, a study found that black respondents spent almost twice as much on lottery tickets than white and Hispanic respondents. *Id.*

²¹⁶ See Statman, *supra* note 40, at 20 (arguing that one motivation to restrain gamblers stems from the “envy of the upstart and a desire of the ruling elite to keep its high relative position in society”).

²¹⁷ See BARKER & BRITZ, *supra* note 129, at 22 (giving as one example Denmark Vesley, who bought his freedom with his \$1,500 gambling winnings).

²¹⁸ *Id.*

²¹⁹ Bridwell & Quinn, *supra* note 24, at 622-23 (citing 12 Rich. II c. VI (1388) (Eng.)).

²²⁰ DAVIES & ABRAM, *supra* note 1, at 16 (describing how legislators prohibited “poolrooms” where less affluent bettors could place bets through telegraph lines without having to pay admission or transportation fees).

²²¹ FABIAN, *supra* note 28, at 50-51.

²²² See Statman, *supra* note 40, at 19-20.

III. COMPARING APPLES TO APPLES: REGULATING SPECULATION ACTIVITIES BASED ON CHANCE, SKILL, AND UTILITY

Leaving aside both ends of the spectrum,²²³ which are purely activities of chance, regulated as gambling, and activities of skill, regulated, if at all, as economic enterprises, the groupings within the spectrum should be regulated similarly. Activities within these groups have similar levels of chance and skill, as well as similar levels of utility, entertainment value, and social costs. Therefore, a coherent system of regulation would treat these groups similarly.

A. *Type A Speculation*

Type A speculation activities, including blackjack, poker, derivatives, and day trading, have dramatic differences in the level of regulation that each inspires, although the activities have similar levels of positive utility and social costs. Blackjack and poker are strictly regulated, even prohibited in a majority of states, along with other types of casino gambling.²²⁴ On the other hand, sellers of derivative products have enjoyed recent liberalization of rules restricting sales of futures contracts to the exchanges supervised by the Commodity Futures Trading Commission.²²⁵ Investors have nearly unfettered ability to purchase derivatives on almost any financial product or other benchmark.²²⁶ In addition, although the SEC approved two new National Association of Securities Dealers (NASD) rules in the aftermath of the 2001 dot-com bust to protect “pattern day traders,”²²⁷ day trading is virtually as encouraged by the SEC as any other kind of stock trading. Any individual can boot up a computer and, with a credit card, legally become a day trader in a matter of minutes.

These activities should be regulated similarly. Day trading and investing in derivatives have all the hallmarks of skill-based gambling activities like blackjack and poker and also have all the negative social costs associated with these activities. As easily as someone could lose money and become addicted to poker, someone else could lose money and become addicted to day trading or speculating on exotic derivative instruments.²²⁸ Just as there are cautionary

²²³ See Figure 1, *supra*, Part I.A.

²²⁴ See MASON & NELSON, *supra* note 14, at 37, 62-63 (commenting that only eleven states allow commercial casinos, although twenty-four states allow tribal casinos).

²²⁵ Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000) (codified as amended at 7 U.S.C. § 1).

²²⁶ Prior to the Commodity Futures Modernization Act of 2000, large markets for exotic financial derivatives were conducted off-exchange. Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 764 (1999).

²²⁷ See 66 Fed. Reg. 13608, 13609 (Mar. 6, 2001) (defining “pattern day trader” as someone who buys and sells – or sells short and then buys – the same stock within one day and does this four or more times in five consecutive business days).

²²⁸ According to Professors Hamilton and Booth, “[a]bout 90 percent of all individual

tales of bright people ruining their lives by playing poker,²²⁹ tales abound of bright people losing their nest eggs by actively trading. In fact, corporations full of bright people have lost corporate nest eggs by purchasing derivatives that were not understood.²³⁰

If governments are concerned enough about the first group of compulsive gamblers to prohibit casino gambling and similar types of games, then concern for compulsive investors should result in the same prohibition against market speculation. Conversely, if governments want to assume that rational investors should be free to control their own destiny in the capital markets, then gamblers should be granted the same autonomy.

B. *Type B Speculation*

Sports betting and stock trading, Type B speculation, also represent a departure in the regulation of speculation. As discussed previously,²³¹ sports betting is the most prohibited type of gambling in the United States, although arguably the most prevalent. Stock trading, however, is generally encouraged in all U.S. jurisdictions. Both activities provide a similar type of entertainment value, a similar indirect economic utility, and similar social costs, and thus they should be regulated similarly.

Both stock trading and sports betting are enormously interesting activities. Their existence spawns an interest in the underlying industry, whether it is a particular sport or team or a particular industry or company. They also spawn economic activity in the underlying industry. The existence of a gambling market sells sports tickets, pay-per-view programming, sports programming, sports magazines, and fantasy sports league fees.²³² Likewise, the existence of a secondary trading market encourages original investment in corporations through the promise of a market for common stock.²³³ However, both gambling and stock trading have internal and external costs. For both the compulsive gambler and trader, losses may be substantial, and we know that the average speculator in these activities loses money. In addition, these activities have external costs. Gambling may harm an industry by creating

commodity speculators lose money" HAMILTON & BOOTH, *supra* note 65, at 426.

²²⁹ See Daniel G. Habib, *Online and Obsessed*, SPORTS ILLUSTRATED, May 30, 2005, at 66 (telling the story of one college student who owed \$55,000 in gambling debts, even though his father had paid off his gambling debts once previously).

²³⁰ MALKIEL, *supra* note 72, at 290 (retelling the story of how Proctor & Gamble lost \$100 million on a foreign interest rate derivative); see *The Proctor & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1292 (S.D. Ohio 1996) (denying most claims of P&G against its counterpart in a risky foreign interest rate derivative).

²³¹ See *supra* Part I.D.1.

²³² ROSE & OWENS, *supra* note 33, at 44-45 (predicting that because ESPN and other "media giants" benefit from fantasy leagues, enforcement of sports betting laws in this area will be infrequent).

²³³ SODERQUIST & GABALDON, *supra* note 17, at 26-27. Companies issuing stock also gain the ability to pay executives and other employees in stock. *Id.* at 27.

scandals.²³⁴ Irrational trading may bring inefficiencies to the market, causing the market to fail in its function of providing accurate price information. In nightmare scenarios, managers of pension funds may create almost limitless negative effects on various groups through reckless trading.²³⁵

If sports betting is sinister enough to the participants and the sport to be banned in almost every state and the District of Columbia,²³⁶ then stock trading should also be banned. Conversely, if stock trading provides enough utility to the market not only to permit it but to encourage it, then sports betting should be deregulated. Regulation should not prefer a vehicle that primarily confers benefits on highly educated, wealthy financial intermediaries to a vehicle that primarily confers benefits on perhaps less-educated, but often just as wealthy bookmakers and casinos.

C. *Insider Speculation: Sure Bets*

Although the arguments for decriminalizing insider trading²³⁷ are outside the scope of this article, the securities industry may be able to learn from the sports industry, which has adopted a policy that allowing insiders to gamble on their own sport skews motivations and sullies the game. Perhaps this policy could inform whether insiders should own shares in their own companies, whether insiders should own stock options, and whether insiders should be required to announce stock sales before rather than after execution of the sale. However, the sports industry might be able to learn about incentive compensation and decide that allowing players to bet on their own team's success would motivate players and keep them in the game.²³⁸

IV. REGULATING FOR THE OUTLIER: THE RECKLESS GAMBLER AND THE RECKLESS INVESTOR

A. *Caveat Speculator*

To attempt to understand why gambling has historically been restricted

²³⁴ See DAVIES & ABRAM, *supra* note 1, at 23 (retelling the fabled story of the 1919 Black Sox scandal).

²³⁵ See Mary Williams Walsh, *How Wall Street Wrecked United's Pension*, N.Y. TIMES, July 31, 2005, § 3, at 1 (describing how United Airlines' risky portfolio contributed to its underfunding and resulting bailout by the Pension Benefits Guaranty Corporation).

²³⁶ NGISC REPORT, *supra* note 15, at 2-14.

²³⁷ See generally Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443 (2001).

²³⁸ However, this seemingly innocuous allowance could create conflicts of interest on the margin due to the nature of sports bets. The 1958 Super Bowl win by the Colts is marred by the suspicion that the owner called for a last-minute touchdown play, instead of a less risky field goal, because he had bet that the Colts would beat the line. DAVIES & ABRAM, *supra* note 1, at 97-99.

while similar investment activities have not, comparing regulators' views of the participants, not the activity, may be helpful. Interestingly, although both the securities industry and the gambling industry acknowledge that certain individuals may be susceptible to dangerous behavior in both arenas, the securities regulatory regime assumes a "rational speculator."²³⁹ However, many U.S. jurisdictions that outlaw or restrict gambling assume an irrational speculator who should be protected from behavioral biases.²⁴⁰ In contrast, securities law policies reflect a regulatory approach based on the premise that investors are rational actors who make informed choices.

To ensure consumer protection in both industries, regulators assume that participants rationally analyze all known facts and so focus on policing whether the facts known to the actors are true. Public companies disclose financial statements, and the SEC has enforcement mechanisms in place to provide comfort that those statements are true in all material respects. Similarly, casinos offer games of chance, and regulators have monitoring mechanisms in place to ensure that those games are operating according to the laws of chance and are not fraudulently modified. However, securities regulators ignore or only give passing acknowledgment of the speculator who makes decisions in spite of known facts, although legislators seem sensitive to the irrational gambler.

B. *The Sympathetic Speculator: Profiling the Herd*

In legal scholarship, scholars have recently begun to challenge the law's assumption that all industry actors, including actors in the securities industry, act rationally given all known information. These scholars challenge "rational choice theory" with "behavioral economics theory," positing that individuals act according to certain behavioral biases that conflict with rational decision making.²⁴¹ These behavioral biases, described in the context of how individuals make decisions given uncertain outcomes, are equally as apparent in the behavior of gamblers as investors, thus providing further argument that the two activities should be regulated similarly. Recognition of behavioral biases does not then demand either the prohibition of securities trading or gambling. However, acknowledging these factors may assist in harmonizing

²³⁹ See Chris Guthrie, *Prospect Theory, Risk Preference, and the Law*, 97 NW. U. L. REV. 1115, 1149 (2003) ("Recognizing that investing in securities is fraught with risk and uncertainty, cognitive psychologists and behavioral economists have raised formidable challenges to the long-dominant assumption that investors, investment managers, and brokers behave rationally.").

²⁴⁰ See ROSE & OWENS, *supra* note 33, at 122-41 (showing how the classification of "pathological gambling" as a mental disorder has influenced state legislation and tort causes of action).

²⁴¹ Guthrie, *supra* note 239, at 1149 (commenting that scholars have begun to draw upon "cognitive psychology to analyze securities markets, securities disputes, and securities regulation").

these regimes. Although scholars have hesitated to conclude that these theories should reform the regulation of markets based on rational actors, these theories do offer interesting explanations of anomalies in earlier assumptions.²⁴²

1. Prospect Theory

Both investors and gamblers tend to make decisions on wagers based on prospect theory, the theory that investors will accept more risk to avoid a loss than to achieve a gain.²⁴³ The typical example of this “bird in the hand” theory is that investors would choose to receive \$1,000 over a fifty percent chance at a \$2,000 pot.²⁴⁴ But, the same investor would accept a “double or nothing” bet of accepting a fifty percent chance of paying a \$2,000 fine instead of paying a \$1,000 fine now.²⁴⁵ Each of these options has the same economic value of \$1,000, but an investor will “irrationally” choose one option over another based on whether the decision is framed as the prospect of gain or the avoidance of a loss. Therefore, to avoid ending a gambling session at a loss, a speculator may be willing to take on more risk.²⁴⁶ Similarly, an investor may wait longer to sell a stock, in hopes of avoiding recognizing a built-in loss.²⁴⁷ In addition, both investors and gamblers may consider a wager to be a loss-avoiding tactic, even if the loss to be avoided is not an actual out-of-pocket loss but a downward deviation from a psychological baseline.²⁴⁸ Therefore, if an investor believes that she is behind on saving for retirement, she may take on more risk to avoid falling behind on that goal.²⁴⁹ An investor may also measure a baseline as relative to how much others have profited from the markets.²⁵⁰

A corollary to prospect theory, and one that is highly applicable to both investing and gambling, is that this preference tends to reverse when the

²⁴² See Langevoort, *supra* note 69, at 138-39 (proposing the inclusion of behavioral theory as a factor in thinking about securities law).

²⁴³ See Guthrie, *supra* note 239, at 1150 (discussing the prospect theory as it applies to investor behavior).

²⁴⁴ *Id.* at 1118 (building on research by Daniel Kahneman and Amos Tversky on decision making).

²⁴⁵ *Id.*

²⁴⁶ REBER, *supra* note 37, at 357 (discussing the gambler’s temptation to make high risk wagers to end the day in the black and how horse racetracks take advantage of this by having high risk wagers on the last race).

²⁴⁷ Langevoort, *supra* note 69, at 144.

²⁴⁸ Guthrie, *supra* note 239, at 1149-50.

²⁴⁹ *Id.*

²⁵⁰ Langevoort, *supra* note 11, at 638-39 (providing as an example an investor who believes that she has not capitalized on a bull market after hearing of other’s profits and who consequently wants to regain lost ground).

probabilities get increasingly smaller.²⁵¹ In both speculative investing and gambling, the probabilities are small and the gains are large.²⁵² So, a gambler will choose to forego a small amount of money for a small probability of a large gain. A gambler will choose not to accept one dollar, but instead a one percent chance of a \$100 pot, even though these options have the same economic value. However, someone would choose to pay one dollar to avoid a one percent chance of paying a \$100 fine. Thus prospect theory explains both why gamblers choose to buy cheap lottery tickets and why investors purchase stock options.

2. House Money

Related to prospect theory is the theory that investors and gamblers will be more willing to take risks with “found money” or “house money.”²⁵³ If prospect theory tells us that speculators value more strongly money that they already possess, then speculators will place less value on and take greater risks with investment profits and gambling winnings. Unfortunately, this bias may also affect securities professionals who manage other people’s money.²⁵⁴

3. Speculator Overconfidence

Although statistics tell both investors and gamblers that the average speculator will lose money betting on sports, playing blackjack, playing “L” games, buying derivatives, or trading in stocks, individual speculators believe that they can succeed in these lopsided endeavors. Part of the popularity of these games may be due to overconfidence of players and the tendency of most players to assume that they are more skilled than the average player.²⁵⁵ Professor Stout has described these markets as “Lake Wobegon” markets, where all speculators believe their skills are above average.²⁵⁶ In fact, the great majority of active traders will label themselves as “above average” compared

²⁵¹ Guthrie, *supra* note 239, at 1118.

²⁵² For example, on August 3, 2005, an investor could purchase an option to buy common stock in Krispy Kreme Doughnuts, Inc. (KKD) for five cents with an exercise price of ten dollars that expires on August 31. The probabilities of the stock increasing to over ten dollars from \$7.71 in twenty-eight days are quite low considering that KKD’s stock price has been lower than ten dollars since January 4, 2005. However, should the stock rise to eleven dollars, a fifty dollar wager would yield a \$1,000 return.

²⁵³ See REBER, *supra* note 37, at 349 (describing illogical betting systems that encourage gamblers to increase bets after winning because gamblers are now betting with the casino’s money).

²⁵⁴ See Langevoort, *supra* note 11, at 643-45 (hypothesizing that managers’ structural incentives probably lessen the effect of behavioral biases but observing that these managers do seem to be susceptible to both prospect theory and overconfidence).

²⁵⁵ SHEFRIN, *supra* note 113, at 48.

²⁵⁶ Stout, *supra* note 12, at 637.

to other traders.²⁵⁷ In addition, volumes of literature on how to beat both the stock market and the casinos perpetuate this myth of control over mathematical odds, and both gambling professionals and securities professionals market “systems” that purport to beat the odds.²⁵⁸ Moreover, the mere accessibility and abundance of information on markets may also give speculators an irrational sense of confidence.²⁵⁹

4. Illusion of Control

Related to overconfidence bias is the illusion of control. In some games, such as craps, where the player physically controls the operation of chance by throwing the dice, players are more susceptible to this illusion that the player is in control of the game.²⁶⁰ Day traders who can trade directly through an Electronic Communications Network may also believe they wield more control than traders acting through intermediaries.²⁶¹ This illusion may also encourage traders to trade more frequently.²⁶²

5. Representation

One aspect of representation bias is simply that the recent occurrence of random events affects a person’s belief in the likelihood of that event happening again.²⁶³ For example, when a particular convenience store sells the “winning ticket,” other lottery players will flock to that location the next week.²⁶⁴ Likewise, media coverage of recent initial public offerings in a

²⁵⁷ Langevoort, *supra* note 69, at 146.

²⁵⁸ See generally, e.g., GERALD APPEL, WINNING MARKET SYSTEMS: 83 WAYS TO BEAT THE MARKET (1997) (teaching various systems for stock trading); MARTEN JENSEN, BEAT THE SLOTS: LEARN THE INSIDE SECRETS OF BEATING TODAY’S NEW MACHINES (2002) (on file with author) (capitalizing on gamblers’ overconfidence by promising that “by learning about the games and by using a methodical approach, you are much more likely to come out ahead than those poor, unenlightened amateurs”). Through technological advances, investors can not only buy books that explain stock trading systems, but they can also buy software marketed as investment training software. Bradley, *supra* note 70, at 310-11.

²⁵⁹ See Langevoort, *supra* note 69, at 154 (contending that the emergence of the Internet in the 1990s brought about an “explosion in web-based investment information” that “operated as a substitute for brokerage firm guidance, supporting (if not inflating) the sense of confidence for the real investor”).

²⁶⁰ See REBER, *supra* note 37, at 64 (suggesting that craps is tempting because it is the only Type L game in which the wagerer plays a part in the outcome by throwing the dice).

²⁶¹ See SHEFRIN, *supra* note 113, at 133 (stating that this heuristic is “especially acute when it comes to online trading, Internet stocks, and day trading”).

²⁶² *Id.*

²⁶³ Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1125 (1974).

²⁶⁴ Kearney, *supra* note 48, at 294 (finding that retailers in Texas between 2000 and 2002 experienced sales increases of between twelve and thirty-eight percent during the week following sales of winning tickets in those same stores).

certain industry with big first-day stock price increases attract retail investors to the next IPO of a firm in that industry.²⁶⁵

V. REGULATING INTERNET SPECULATION

Historically, retail participation in the stock market and organized gambling were limited by natural transaction barriers. To invest in the stock market, an investor had to locate a broker who would make the trade for them, charge them a commission, and require a minimum balance to open an account. Information on publicly-traded companies was not widely available beyond stock price information published in the newspapers of larger cities. Both to obtain investment information and to buy or sell stock, a retail investor had to encounter an intermediary – the broker – along the way. Likewise, access to casino gambling was limited by geographical restraints. Even organized gambling in sporting events required locating a bookmaker. With the advent of computers, cable television, and the Internet, would-be investors and gamblers have round-the-clock access to both participation and information. Via online brokerage houses,²⁶⁶ investors can buy and sell stock over the Internet at discounted fees at any time of day without going through an intermediary. Reckless investors whose trading strategies may have been tempered by the transaction costs of trading are now freer to actively manage their own portfolios in the privacy of their own homes. Likewise, gamblers may visit online casinos and place wagers from their homes, workplaces, or favorite coffeeshops. Occasional vacationers to Atlantic City or Las Vegas can now gamble online without travel costs, and amateur players intimidated by the strange customs of the gaming tables can learn blackjack anonymously. Generally, the SEC has applauded the destruction of barriers between retail investors and the capital markets.²⁶⁷ However, the federal government has not been as welcoming of online gambling.²⁶⁸

A. *Embracing Online Trading*

In 1984, the SEC acknowledged that computer brokerage systems were being developed and that the contact between brokers and investors would be narrowed.²⁶⁹ Over the next fifteen years, brokerage systems evolved from investors trading by telephone in established accounts to investors establishing

²⁶⁵ See SHEFRIN, *supra* note 113, at 240-43 (studying the effect of the widely publicized 1993 IPO of Discovery Zone, which resulted in a 61 percent profit on the first day, on the subsequent IPO of Boston Chicken, a company whose stock increased 142.5 percent the first day but which eventually declared bankruptcy).

²⁶⁶ See *id.* at 133 (describing Merrill Lynch's surrender to online trading on June 1, 1999, as a monumental event).

²⁶⁷ See *infra* Part V.A.

²⁶⁸ See *infra* Part V.B.

²⁶⁹ Computer Brokerage Systems, Exchange Act Release No. 21,383, 31 SEC Docket 611 (Oct. 9, 1984).

accounts through home computers and trading online within minutes. By 2000, online trading accounted for twenty to twenty-five percent of all stock trading,²⁷⁰ and by 2001, more than 100 online trading firms were in operation.²⁷¹ The rise of the online investor spawned a new industry devoted to delivering financial and industry information on publicly-held companies in speedier formats such as cable television and Internet websites.²⁷² Technology also allowed some firms to offer active trading clients direct access to markets through Electronic Communications Networks (ECNs) at their locations.²⁷³

Although the overall utility of online trading to the investor was negative, the SEC viewed Internet trading as merely stock trading over the Internet, to be regulated the same way as traditional stock trading.²⁷⁴ Notwithstanding evidence that online trading “contributed to a nontrivial reduction in market efficiency,”²⁷⁵ the SEC continued to regulate as if all investors, whether online or under the supervision of a trusted financial advisor, acted rationally given all known information. Even though SEC officials have conceded that the stock market is for stock holding, not for stock trading,²⁷⁶ the SEC has generally never restricted stock trading. Although we might not expect the SEC to regulate to protect a subset of investors, negative external effects of online trading such as price bubbles and price anomalies have also not effected changes in securities laws.

Online investing can also be described as being specifically tailored to take advantage of an overly confident investor.²⁷⁷ Mirroring the ways in which

²⁷⁰ Donald C. Langevoort, *Technological Evolution and the Devolution of Corporate Financial Reporting*, 46 WM. & MARY L. REV. 1, 7 (2004) (“some twenty percent”); Levitt, *supra* note 68, at 1095 (“twenty-five percent”).

²⁷¹ Matthew J. Benson, Note, *Online Investing and the Suitability Obligations of Brokers and Broker-Dealers*, 34 SUFFOLK U. L. REV. 395, 396 (2001).

²⁷² See Bradley, *supra* note 70, at 309 (“Investors can now obtain information about investments and investment strategies through print and broadcast media, in person through investment seminars, and online through financial portals, broker-dealer web sites, and chat rooms.”).

²⁷³ See Bradley, *supra* note 71, at 68-69 (describing the differences between ordinary online traders and day traders who blur the line between being a client of a day trading firm and an employee or principal).

²⁷⁴ However, the SEC did approve NASD rulemaking requiring detailed risk disclosures to day trading clients. Order Approving Proposed Rule Change Relating to the Opening of Day-Trading Accounts, 65 Fed. Reg. 44,082, 44,083 n.9 (July 17, 2000). The next year, NASD also passed new Rule 2520, requiring “pattern day traders” to maintain \$25,000 in their day trading account and not trade more than four times the excess amount in a day. Order Approving Proposed Rule Changes Relating to Margin Requirements for Day Trading, 66 Fed. Reg. 13,608, 13,609 (Mar. 6, 2001).

²⁷⁵ Langevoort, *supra* note 270, at 9.

²⁷⁶ Levitt, *supra* note 69, at 1096 (“As far as I am concerned, for most individuals, the stock market is best used for investing, not trading.”).

²⁷⁷ See *id.* at 1096 (warning that unsophisticated investors may be “seduced by the ease

casinos alter the experience to entice gamblers, issuers learned how to time financial disclosures and spin them to “a more emotional, less sophisticated audience.”²⁷⁸ Online trading may create a corresponding incentive for issuers to focus on short-term financial benchmarks that play well with the day trading crowd.²⁷⁹ In addition, complementary products to online investing, such as web-based information and training software, may take advantage of investors’ vulnerabilities by enticing them to make decisions from bits of information amassed in a non-linear format.²⁸⁰ Finally, online brokerage advertising has received criticism, but not regulation, for seeming to promise independent wealth to every trader, being compared in this regard to lottery advertisements.²⁸¹

Compared to traditional arguments against gambling, official stances on investing have steered away from acknowledging that the capital markets are dangerous to the retail investor or that the participation by retail investors in the capital markets has negative external effects.²⁸² The SEC has embraced the vision of retail investor participation,²⁸³ a dream that is lucrative for financial intermediaries and psychologically satisfying for the American people. To restrict retail investor access to the capital markets based a technological medium²⁸⁴ would require a policy articulation that is unpalatable. Instead, technological advances such as online investing have merely prompted

and speed of Internet trading”).

²⁷⁸ Langevoort, *supra* note 270, at 9-10.

²⁷⁹ *Id.* at 16.

²⁸⁰ See Bradley, *supra* note 70, at 314 (quoting “cyberpsychologists” Luciano Gamberini and Stefano Bussolon, who “suggest using the Internet to obtain information may promote ‘nonlinearity in the exploration of knowledge’ and ‘communication via impressions rather than logical connections’”).

²⁸¹ See Levitt, *supra* note 68, at 1099 (criticizing these ads for creating unrealistic expectations in online traders); see also Benson, *supra* note 271, at 395 (describing one brokerage’s ad featuring a fictional former tow-truck driver who, through the magic of online trading, came to own his own island).

²⁸² See Langevoort, *supra* note 69, at 173-74 (acknowledging that regulation that distinguishes between unsophisticated traders and the financially “savvy” would be “impossible to advocate openly”).

²⁸³ See *id.* at 173 (referring to this democratization dream as a “myth-story” in which rational investors are only constrained by a lack of access to information, thus shifting the focus of regulation to information disclosure).

²⁸⁴ The SEC does restrict investor participation in some instances. For example, to be exempt from registration under a Regulation D offering, the SEC requires that investors have sufficient resources to bear any ensuing loss. Distinguishing between accredited and non-accredited investors, the SEC presumes, but does not confirm, that these high net worth accredited investors – primarily institutional investors and individuals with a net worth over one million dollars – have “such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment.” 17 C.F.R. §§ 230.501(a), 230.506(b)(2)(ii) (2006).

reminders from the SEC that investors be more aware of their individual responsibility.²⁸⁵

B. *Exiling Online Gambling*

The federal government, which has traditionally left the regulation of gambling to the individual states, has taken the position that Internet gambling is illegal under federal law²⁸⁶ under the Wire Act, which prohibits the use of a “wire communication facility for the transmission in interstate or foreign commerce of bets or wagers . . . on any sporting event or contest.”²⁸⁷ The ambiguities that surround the federal government’s use of the Wire Act to indict remote gaming sites arise in the interpretation of “wire communication facility” and “sporting event or contest.”²⁸⁸ Currently, the federal government has taken the position in prosecutions that the Wire Act covers all illegal gaming, not just sports betting,²⁸⁹ and that the Wire Act governs all Internet gambling, even wireless use.²⁹⁰ Most recently, one federal court has disagreed.

²⁸⁵ See Levitt, *supra* note 68, at 1096 (“Specifically, an individual investor has a duty to understand and control the level of risk she is assuming.”).

²⁸⁶ *Unlawful Internet Gambling Funding Prohibition Act and the Internet Gambling Licensing and Regulation Commission Act: Hearing on H.R. 21 and H.R. 1223 Before the Subcomm. on Crime, Terrorism, and Homeland Security of the H. Comm. on the Judiciary*, 108th Cong. 8-12 (2003) [hereinafter “2003 Hearing on H.R. 21 & H.R. 1223”] (statement of John G. Malcolm, Deputy Assistant Att’y Gen., Criminal Division, U.S. Department of Justice) (reporting that the DOJ “has concerns” about the feasibility of regulating Internet gambling as proposed in H.R. 1223, and that the DOJ believed that Internet gambling should be prohibited and not regulated).

²⁸⁷ 18 U.S.C. § 1084 (2000 & Supp. 2004); see also Joseph V. DeMarco, *Gambling Against Enforcement – Internet Sports Books and the Wire Wager Act*, U.S. ATT’YS BULL., Mar. 2001, at 33, 33 (explaining how the Wire Act applies equally to web-based bookmakers and “traditional ‘pay-phone’ bookies”).

²⁸⁸ See 18 U.S.C. § 1084(a) (2000 & Supp. 2004).

²⁸⁹ *Compare Proposals to Regulate Illegal Internet Gambling: Hearing on Proposals to Regulate Illegal Internet Gambling, Including S. 627, to Prevent the Use of Certain Payments Instruments, Credit Cards, and Fund Transfers for Unlawful Internet Gambling: Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 8 (2003) (statement of John G. Malcolm, Deputy Assistant Att’y Gen., Criminal Division, U.S. Department of Justice) (claiming that any business that accepts any kind of bet or wager from customers located in the United States violates the Wire Act) with *Internet Gambling Prohibition Act of 1997: Hearings on H.R. 2380 Before the Subcomm. on Crime of the H. Comm. on the Judiciary*, 105th Cong. 81 (1998) (statement of Kevin V. DiGregory, Deputy Assistant Att’y Gen., Criminal Division, U.S. Department of Justice) (conceding that the Wire Act “may relate only to sports betting and not to the type of real-time interactive gambling (e.g., poker) that the Internet now makes possible for the first time”).

²⁹⁰ See Letter from Jon P. Jennings, Acting Assistant Att’y Gen., Department of Justice, to Patrick J. Leahy, Ranking Minority Member, Comm. on the Judiciary, U.S. Senate (June 9, 1999), <http://www.usdoj.gov/criminal/cybercrime/s692ltr.htm> (stating that the Internet constitutes a “wire communications facility” even though it may travel over microwaves or

In a civil action against credit card companies, the Fifth Circuit reasoned in dicta that the Wire Act does not apply to non-sports gaming over the Internet, such as online casinos.²⁹¹ The U.S. government has taken the position that Internet gambling takes place both in the jurisdiction in which the gambler resides and in the jurisdiction that hosts the website.²⁹² Therefore, if a U.S. resident gambles on an offshore website, then the act is illegal under both state and federal law.

The flourishing of Internet gaming has been aided by the fact that the U.S. stance against Internet gambling is not a global one. Other countries have legalized Internet gambling and license companies to run gambling websites.²⁹³ Since 1995, many Internet sites have been created that offer players the ability to make wagers on simulated casino games, multi-player games such as poker, and even sports outcomes.²⁹⁴ Currently more than 1,800 websites are in existence,²⁹⁵ and these websites generated approximately \$7.4 billion in revenue in 2004.²⁹⁶ These websites, of course, are accessible by citizens in other countries, including the United States, where residents constitute sixty to seventy percent of online gamblers.²⁹⁷ The owners of these websites, however, are not available to the U.S. government for prosecution. Although some of these websites are characterized by opponents of online

satellites because wire and cable “aid in the transmission of data between ‘the points of origin and reception of such transmission’”).

²⁹¹ *In re Mastercard Int’l Inc. Internet Gambling Litig.*, 313 F.3d 257, 263 (5th Cir. 2002) (rejecting the argument that amounts owed to the credit card company were accumulated amounts wagered on online casino sites and thus illegal and uncollectible, by stating “[b]ecause the Wire Act does not prohibit non-sports internet gambling, any debts incurred in connection with such gambling are not illegal”).

²⁹² See Statement of Kevin V. DiGregory, Deputy Assistant Att’y Gen., Criminal Division, Before the H. Subcomm. on Crime, Comm. on the Judiciary, U.S. H.R., Concerning Gambling on the Internet (June 24, 1998), <http://www.usdoj.gov/criminal/cybercrime/kvd0698.htm> (“It is the position of the Department of Justice that a wager, including an electronic or phone wager, occurs in the location it is placed and in the location in which it is received.”).

²⁹³ Gottfried, *supra* note 145, ¶ 1 (reporting that, in 2003, fifty-four foreign governments allowed Internet gambling).

²⁹⁴ See, e.g., Casino City, <http://www.casinocityonline.com> (last visited Apr. 2, 2006); Party Poker, <http://www.partypoker.com> (last visited Apr. 2, 2006); World Sports Exchange, <http://www.wsex.com> (last visited Apr. 2, 2006).

²⁹⁵ Lawrence G. Walters, *The Law of Online Gambling in the United States – A Safe Bet, or Risky Business?*, 7 GAMING L. REV. 445, 445 (2003) (citing over 1,800 sites and 14.5 million users in 2003).

²⁹⁶ Lorraine Woellert, *Can Online Betting Change Its Luck?*, BUSINESS WEEK, Dec. 20, 2004, at 66.

²⁹⁷ Kim Komando, *In Battle Against Online Gambling: Don’t Bank on It*, CHICAGO SUN-TIMES, Apr. 25, 2005, at 63 (sixty to sixty-five percent); Woellert, *supra* note 296, at 67 (seventy percent).

gambling as being countries with little or no financial regulation,²⁹⁸ several large websites are based in the United Kingdom and in Australia, where Internet gambling is legal, but highly regulated.

In the United Kingdom, for example, online gaming is legal and popular. In fact, PartyGaming, a U.K. company founded by U.S. expatriates, went public in June 2005, fully disclosing the fact that ninety percent of its customer base lived in the United States, a country that stubbornly insists that Internet gaming by U.S. residents is illegal.²⁹⁹ PartyGaming's registration statement contained this risk disclosure: "In many countries, including the United States, the group's activities are considered to be illegal by the relevant authorities. PartyGaming and its directors rely on the apparent unwillingness or inability of regulators generally to bring actions against businesses with no physical presence in the country concerned."³⁰⁰

1. Public Policy Relating to Prohibiting Internet Gambling

Stated fears concerning Internet gambling are many. However, they are mere reiterations of concerns expressed about gambling generally. Even the Department of Justice (DOJ), under the Clinton Administration, warned that any regulatory response to Internet gambling should treat activity that occurs on the Internet no differently than the same activity that occurs in the physical world.³⁰¹ Regulation should focus on the activity to be prohibited, not on the manner in which that activity is delivered.³⁰² Activity that is legal in the physical world should not be criminalized merely because it occurs on the Internet. The following arguments made by online gambling opponents focus on the social costs of gambling, which are equally applicable to traditional gambling. In addition, comparisons of Internet gambling to traditional gambling are not quite apt because the comparison is of an unregulated activity

²⁹⁸ Unlawful Internet Gambling Funding Prohibition Act, H.R. 556, 107th Cong. § 2(4) (2001) ("Internet gambling conducted through off-shore jurisdictions has been identified by United States law enforcement officials as a significant money laundering vulnerability."); see Statement of Kevin V. DiGregory, *supra* note 292 (naming as countries with remote gambling sites in 1998 the countries of Antigua, Curacao, Grenada, the Dominican Republic, Netherland Antilles, Trinidad, St. Vincent, and the Cayman Islands).

²⁹⁹ Kurt Eichenwald, *At PartyGaming, Everything's Wild*, N.Y. TIMES, June 26, 2005, § 3, at 1 (reporting that PartyGaming, although offering its shares in London, is licensed by Gibraltar).

³⁰⁰ *Id.*

³⁰¹ *Internet Gambling Funding Prohibition Act: Hearing on H.R. 4419 Before the H. Comm. on Banking and Financial Services*, 106th Cong. 69-70 (2000) (statement of Kevin V. DiGregory, Deputy Assistant Att'y Gen., Criminal Division, U.S. Department of Justice).

³⁰² *Internet Gambling Prohibition Act of 1999: Hearing on H.R. 3125 Before the Subcomm. on Crime of the H. Comm. on the Judiciary*, 106th Cong. 36 (2000) [hereinafter "2000 Hearing on H.R. 3125"] (statement of Kevin V. DiGregory, Deputy Assistant Att'y Gen., Criminal Division, U.S. Department of Justice).

to a highly regulated activity.³⁰³ Any comparison should be of *regulated* Internet gambling to traditional gambling.

a. *Increases in Problem Gambling*

One of the most cited reasons for prohibiting Internet gambling is that it will create new problem gamblers. This argument will only be persuasive if online gambling is more likely to cause gambling addiction than conventional gambling due to characteristics inherent in online gambling.³⁰⁴ The following sections refute the most common arguments against online gambling.

1. Twenty-Four-Hour Access

Any person with access to a computer, an Internet connection, and some way to send money either through the mail or electronically can gamble on an Internet site in a matter of minutes. Once gambling, the player can play nonstop because online casinos never close. This “virtually unfettered access” has raised concerns that online gaming can unfairly harm gamblers.³⁰⁵

Most physical casinos never close either. Although some states that have legalized casinos have attempted to pass legislation forcing casinos to close for one or two hours a day, these measures do not seem to have much staying power.³⁰⁶ As it is, anyone that lives close to a casino or who travels to a casino can gamble twenty-four hours a day. In fact, casinos are experimenting with hand-held wireless devices that allow gamblers access to gaming at casino

³⁰³ Gottfried, *supra* note 145, ¶ 13.

³⁰⁴ According to a Gallup Lifestyle Poll conducted December 11-14, 2003, thirty percent of respondents had visited a physical casino in the preceding twelve months, compared to only one percent of respondents who had visited an online casino. Kearney, *supra* note 48, at 283 (reporting also that forty-nine percent had bought a lottery ticket and fifteen percent had participated in an office pool).

³⁰⁵ See 2000 Hearing on H.R. 3125, *supra* note 302, at 34 (statement of Kevin V. DiGregory, Deputy Assistant Att’y Gen., Criminal Division, U.S. Department of Justice) (“[B]ecause the Internet provides people with virtually unfettered access to the opportunity to gamble at any time and from anyplace, Internet gambling presents a greater danger for compulsive gamblers and can cause severe financial consequences for an unsuccessful player.”).

³⁰⁶ So far, Illinois has maintained a two-hour mandated break in gaming, although legislative efforts are underway to remove the restriction. Gambling Magazine, Riverboat Operators Pushing for 24-Hour Gambling Day, <http://gamblingmagazine.com/articles/14/14-490.htm>. All surrounding states have twenty-four hour gaming, including Indiana, Iowa, Missouri, and Wisconsin. American Casino Guide, U.S. Casino Directory: Indiana Casinos, <http://www.americancasino.com/indiana.shtml>; American Casino Guide, U.S. Casino Directory: Iowa Casinos, <http://www.americancasino.com/iowa.shtml>; American Casino Guide, U.S. Casino Directory: Missouri Casinos, <http://www.americancasino.com/missouri.shtml>; American Casino Guide, U.S. Casino Directory: Wisconsin Casinos, <http://www.americancasino.com/wisconsin.shtml>.

swimming pools, restaurants, bars, and convention rooms.³⁰⁷ Moreover, the owners of physical casinos are able to subtly manipulate gamblers into gambling for longer periods of time in ways that an online casino cannot. Many casinos do not have windows or clocks in an attempt to eliminate any sense of time passing for the gamblers. Most computers have a clock on their screen at all times, and gaming websites do not cover up the clock. In addition, most people have clocks in their houses, and being in the house ensures that life will catch up with the gambler: the phone will ring, the doorbell will ring, or other family members will interrupt playing.

2. Gambling at Home

Relatedly, opponents of Internet gambling argue that the presence of gambling opportunities in the home creates an increased risk of problem gambling.³⁰⁸ Gamblers no longer have to leave their house or their place of employment to gamble.³⁰⁹ Secret gamblers will not arouse suspicion by unexplained absences.³¹⁰ These arguments are not persuasive. Admittedly, for the problem gambler who lives alone, the Internet may speed up the gambler's addiction by reducing transaction costs such as transportation and incidental casino costs such as parking, food, and drinks. The farther the problem gambler lives from a legal casino, the more appealing the Internet sites will be.

However, for problem gamblers with familial obligations, gambling at home may be harder to hide than in a casino.³¹¹ Gamblers who may have aroused suspicion by sneaking out of the house for hours at a time may also arouse

³⁰⁷ Fox Butterfield, *Losing Shirt at Casino Pool (It's Wireless)*, N.Y. TIMES, July 2, 2005, at A1 (reporting that while hotel rooms will not be allowed access for fear of minors gambling, access will be available at other minor-friendly venues, such as the pool); see Operation of a Mobile Gaming System, Nev. Gaming Comm'n Regs. 5.220 (Mar. 2006); Associated Press, Nevada Okays Gambling To Go, Mar. 24, 2006, <http://www.cnn.com/2006/TECH/fun.games/03/24/mobile.gambling.ap/index.html> (reporting the Nevada Gaming Commission's decision to allow "the use of handheld devices for gambling in any public area of the state's casinos, such as restaurants and poolsides").

³⁰⁸ See Gregory Manter, *The Pending Determination of the Legality of Internet Gambling in the United States*, 2003 DUKE L. & TECH. REV. 0016, ¶ 6 (2003), <http://www.law.duke.edu/journals/dltr/articles/2003dltr0016.html> (referring to supporters of the Internet Gambling Enforcement Act, which was passed by the U.S. House of Representatives in 2002).

³⁰⁹ 2003 Hearing on H.R. 21 & H.R. 1223, *supra* note 286, at 2 (statement of Howard Coble, Chairman, H. Subcomm. on Crime, Terrorism, and Homeland Security) (referring to gambling in one's own home and remarking, "By making gambling more convenient, it can do nothing but make the problem worse").

³¹⁰ *Id.* at 10 (statement of John G. Malcolm, Deputy Assistant Att'y Gen., Criminal Division, U.S. Department of Justice) (testifying that because Internet gambling is a solitary activity, problem gamblers are able to engage in the activity "uninterrupted" and "undetected").

³¹¹ Gottfried, *supra* note 145, ¶ 29.

suspicion by sitting at the computer for hours at a time. A spouse can more easily look over a gambler's shoulder than find out where a gambler spends unexplained free time. In addition, a worried spouse could track computer use, pore over credit card receipts, or even block use of the computer or credit cards.³¹² Spouses could agree to block websites or self-restrict their computer from websites.

Although websites and software allow computer users to block sites, getting banned from a casino is more difficult. In some casinos, self-aware reckless gamblers, but not concerned third parties, can ask that the gambler be excluded from play or be required to play with cash, not credit.³¹³ Some states require casinos to offer some variation of an exclusion program. For example, the Nevada Gaming Commission requires casinos to allow gamblers to exclude themselves from credit and cash-checking services,³¹⁴ and Missouri requires riverboat casinos to allow gamblers to request exclusion from the casino.³¹⁵ However, even voluntary exclusion programs may have little more effectiveness than merely reminding reckless gamblers to "just say no." Because casinos do not check for identification at the entrance, a reckless gambler who has asked to be restricted from the casino will without fail be allowed to enter the casino. Theoretically, if a dealer or manager recognizes the gambler, he will be escorted out, but any losses incurred before that time would not be returned.³¹⁶ Ironically, however, the casino may be able to disallow winnings because winners must show identification to cash in vouchers and large amounts of chips.³¹⁷ Generally, casinos are reluctant to offer full voluntary exclusion, and few regulators have required them to offer

³¹² See 2003 Hearing on H.R. 21 & H.R. 1223, *supra* note 286, at 14 (statement of Jeffrey Modisett, Counsel, Bryan Cave, LLP) ("Because all Internet gaming transactions are recorded, it is actually easier to track problem gamblers in the cyber world than in the bricks and mortar casino. Self-exclusion and preset loss limits are more easily accomplished.")

³¹³ Harrah's casino offers "Self-Restriction," which requires the casino to suspend marketing, extending credit, or check-cashing services to the gambler, as well as "Self-Exclusion", which terminates play privileges in all Harrah's casinos. Harrah's Entertainment, Inc., Responsible Gaming, Self-Restriction/Self-Exclusion, http://www.harrahs.com/about_us/responsible_gaming/index.html#Self (last visited Apr. 2, 2006). At the Bellagio casino, patrons can request restrictions on mailings and credit services, but not on play privileges. Bellagio Las Vegas, Responsible Gaming, http://www.bellagio.com/pages/frameset_flash.asp (follow "Responsible Gaming" hyperlink) (last visited Apr. 2, 2006).

³¹⁴ Operation of Gaming Establishments, Nev. Gaming Comm'n Regs. 5.170(4) (Nov. 1998), available at http://gaming.nv.gov/stats_regs/reg5.pdf.

³¹⁵ MO. CODE REGS. tit. 11, § 45-17 (2001).

³¹⁶ See *Merrill v. Trump Indiana, Inc.*, 320 F.3d 729, 732-33 (7th Cir. 2003) (finding that Indiana common law does not allow a casino to be sued in tort for failing to evict a gambler requesting his own exclusion).

³¹⁷ See, e.g., MO. CODE REGS. tit. 11, § 45-17.010(3) (2001) ("[A]ll chips, tokens and electronic credits in the possession of a Disassociated Person at the time s/he is discovered on an excursion gambling boat are . . . subject to forfeiture.")

it.³¹⁸

For the recreational gambler with the potential to become a problem gambler, Internet gambling may even hold less appeal than casino gambling. Casino gambling may be entertainment for many tourists, and the sights and sounds of the casino are not readily duplicated on an Internet site. Internet gambling does not have the social aspect that some vacation gamblers may enjoy,³¹⁹ such as free food and alcohol, glitzy show business acts, or even amusing people-watching.³²⁰ Most importantly, Internet casinos do not have managers approaching winner gamblers, persuading them to stay a bit longer with complimentary services (or “comps”).

3. Identification Tracking and Manipulation

Another stated concern is that online gaming software can track individual preferences and tailor a gambling experience to a player’s personality, taking advantage of a player’s weaknesses.³²¹ Consequently, online players could lose more money or be enticed to gamble longer. This argument does not hold up, however, because traditional gambling involves a substantial amount of manipulation of gamblers’ desires as well as identification tracking.

Every aspect of a physical casino is designed to manipulate gamblers. Carpets with bright colors and complicated patterns attract gamblers’ eyes upward, to gambling machines.³²² Aromas designed to engender good feelings surround gamblers sitting at machines.³²³ The casino atmosphere is filled with stimulating lights and sounds. A sixteen-inch computer screen can never compete with the three-dimensional experience of a Las Vegas casino. In addition, players at many physical casinos are offered free alcoholic drinks to lower inhibitions and encourage longer playing.³²⁴

As for preference tracking, many large casinos already gather information on players’ preferences. Harrah’s, a Las Vegas casino, issues customers magnetic membership rewards cards. To entice customers to use these cards,

³¹⁸ *But see, e.g.*, MO. CODE REGS. tit. 11, § 45-17 (2001).

³¹⁹ *See* Statman, *supra* note 40, at 17 (contending that a sense of camaraderie helps to explain the casino visitor’s enjoyment of multi-player games such as poker).

³²⁰ *See* Gottfried, *supra* note 145, ¶ 29 (listing techniques that casinos use to create an environment conducive to gambling, such as “providing free alcohol” and “pumping pleasing scents into slot machine pits”).

³²¹ *See* Adrian Parke & Mark Griffiths, *Why Internet Gambling Prohibition Will Ultimately Fail*, 8 GAMING L. REV. 295, 295 (2004) (“As technology develops there will be increased scope to manipulate the potentially addictive structural characteristics of gambling activities to increase the appeal and arousal of the games.”).

³²² Gottfried, *supra* note 145, ¶ 29.

³²³ *Id.*

³²⁴ American Gaming Association, Fact Sheets: Casino Alcohol Policies, http://www.americangaming.org/industry/factsheets/issues_detail.cfv?id=31 (stating that of the eleven states that allow casino gambling, six states allow the provision of free alcohol).

Harrah's offers reward credits to card users.³²⁵ As players use the cards to make bets, Harrah's collects information on which games the player plays and how much the player bets.³²⁶ Reward credits can only be awarded in person in the casino,³²⁷ facilitating another trip to the casino. Casinos also share the collected customer information with other casinos.³²⁸

Physical casinos also collect and disseminate information on gamblers for other reasons. Through ubiquitous surveillance cameras, casinos compile photographic information on known gamblers who either cheat or "count cards."³²⁹ Larger casinos are equipped with cameras that film every inch of gaming space for various reasons, including detecting customer fraud, dealer fraud, and card counters. As card counters are identified, casinos record their photographs and any other known information, and willingly share that information with other casinos.³³⁰ Thus, physical casinos arguably engage in more identification tracking than do online gaming websites.

4. Losing Intangible Assets Quickly

Some commentators have argued that problem gambling may be exacerbated on the Internet because players wagering with intangible, electronic money can lose money rapidly without noticing.³³¹

Casinos have long realized that putting actual money down for each wager

³²⁵ Harrah's Total Rewards: Program Overview, http://www.harrahs.com/total_rewards/overview/overview.jsp (follow "Benefits" hyperlink) (last visited Jan. 26, 2006):

As a member of Total Rewards, you will be rewarded for your play. . . . You will earn one Base Reward Credit for every \$5 coin-in on reel slot machines (\$10 video poker). For table games and other game types, you will earn Base and Bonus Reward Credits based on your length of play, average bet and the type of game.

See also Kurt Eggert, *Truth in Gaming: Toward Consumer Protection in the Gambling Industry*, 63 MD. L. REV. 217, 282-83 (2004) (explaining that these cards track net wins and losses, then store that information in databases).

³²⁶ Harrah's Total Rewards: Program Overview, *supra* note 325.

³²⁷ *Id.*

³²⁸ For example, Griffin Investigations maintains a database of known card counters, and casinos may subscribe to this database to monitor patrons and compare them to the photos on file. Griffin Investigations, Products and Services, <http://www.griffininvestigations.com/products.html> (last visited April 4, 2006).

³²⁹ Counting cards is not illegal, but casinos identify card counters and bar them from their casinos. This barring may or may not be illegal, but naïve card counters often respond by doing something illegal themselves, like trespassing or disturbing the peace. ROSE & LOEB, *supra* note 53, at 33-47.

³³⁰ *See id.* at 100-01 (describing the Griffin detective agency, which facilitates the compilation and dissemination of information on gamblers among Las Vegas casinos).

³³¹ *See* Jenna F. Karadbil, Note, *Casinos of the Next Millennium: A Look into the Proposed Ban on Internet Gambling*, 17 ARIZ. J. INT'L & COMP. L. 413, 439 (2000) ("The Internet is detached in the sense that there is no 'tangible representation of money' for the [gambler] to see how much she has lost or won.").

inhibits players. The poker chip came into existence in the 1800s and is now used for all kinds of gaming.³³² Chips allow for bets in an assortment of denominations and thus ease liquidity as well as weaken behavioral attachments to cash.³³³ Players can also use bills for slot machines, which increases the speed of the game and gives players the incentive to play until the credit is depleted.³³⁴ Some slot machines even pay out winnings with a voucher, not coins.³³⁵ Vouchers can be used for casino play, thereby encouraging players to keep playing, rather than to stand in line to cash out a voucher.³³⁶ Even if a player is ready to stop gambling for the day, the gambler with a small amount on a voucher might just play one or two more times rather than stand in line to cash out a dollar or two. Internet gambling sites cannot recreate this highly ingenious effort to reclaim each marginal gambling dollar.

Moreover, extensions of credit are incredibly easy to receive at a casino.³³⁷ On the website for Mirage, a Las Vegas casino, players can pre-apply to be able to use their “marker” at gaming tables.³³⁸ The Trump Plaza website also allows players to apply for credit so that they can “rest assured knowing that you won’t need to carry a lot of cash with you.”³³⁹ If electronic cash is dangerously intangible, then being able to gamble without any cash at all is even more dangerous. Casinos will also give cash advances through ATMs with just a swipe of a credit card.³⁴⁰ In addition, casino ATMs will also offer users credit card cash advances when the player’s ATM card has reached its daily withdrawal limit.³⁴¹ Legislative efforts to separate credit cards and ATM

³³² Pete Rizzo, A Short History of Poker Chips in the U.S., <http://www.pokerpages.com/pokerinfo/pokerchips/pokerchip-history.htm> (last visited April 4, 2006).

³³³ See JENSEN, *supra* note 258, at 40 (remarking that most players drop unused tokens in machines as they exit the casino instead of cashing in the chips for cash).

³³⁴ See *id.* at 17 (commenting that most slots will accept bills up to \$100).

³³⁵ See *id.* at 40-41 (describing vouchers as thin pieces of paper, easy to lose or destroy, that expire in thirty days).

³³⁶ Bill Burton, Coinless Slot Machines, <http://casinogambling.about.com/cs/slots/a/coinlesslots.htm> (last visited April 4, 2006) (explaining the “psychological ploy” that vouchers encourage players to play until the voucher has been depleted).

³³⁷ See Gottfried, *supra* note 145, ¶ 97 (reporting that forty to sixty percent of cash wagered in a casino was not brought onto the premises but acquired after arrival through ATM or credit transactions).

³³⁸ Mirage, Las Vegas Casino, <http://www.mirage.com/casino> (last visited Apr. 2, 2006) (follow “Market Application” hyperlink).

³³⁹ Trump Plaza, Credit, <http://www.trumpplaza.com> (last visited Feb. 3, 2006) (follow “Casino” hyperlink; then follow “Credit” hyperlink).

³⁴⁰ Ellen Drought, Note, *Navigating Scylla and Charybdis: In re Brieze, Gambling and Credit Card Debt Dischargeability*, 1997 WIS. L. REV. 1323, 1347 (1997) (describing a Wisconsin casino offering “Cash & Win” checks purchasable by credit card).

³⁴¹ The author observed this practice firsthand during a trip to Mandalay Bay in Las

cards from casino gambling have failed.³⁴² Some slot machine companies have even proposed designing slot machines that accept credit or debit cards issued by banks.³⁴³ In addition, casinos are developing smart debit cards.³⁴⁴ Thus, physical casinos may be ahead of Internet casinos in the race to make cash money disappear easily.

5. Underage Gambling

In all U.S. jurisdictions that allow some form of gambling, players must have reached an age of majority. Generally, patrons of casinos must be twenty-one or older to gamble.³⁴⁵ Most state lotteries allow teenagers eighteen or older to buy lottery tickets, and some states allow younger individuals to redeem them if the buyer transfers the ticket to a minor.³⁴⁶ One common argument against Internet gambling is that underage players will be able to participate more easily by fooling a website into allowing the minor to play.³⁴⁷ In fact, this argument seems to resonate with lawmakers the most.³⁴⁸ However, this argument is not as cogent as it would appear.

First, in countries where Internet gambling is permitted, regulations have been implemented to ensure that players are of legal age. For example, a player may be required to send in physical identification documents, or use some other verification system, before being allowed to play.³⁴⁹

Second, physical casinos are not effectively off-limits to minors. Opponents of Internet gambling point out that traditional casinos have the ability to

Vegas on June 4, 2005.

³⁴² Gambling ATM and Credit/Debit Card Reform Act, H.R. 2572, 107th Cong. (2001) (attempting to prohibit the placement of credit extension devices in the immediate area of a gambling establishment).

³⁴³ Bill Burton, InCREDITibly Stupid Slot Idea, <http://casinogambling.about.com/library/weekly/aa100801.htm> (discussing Innovative Gaming Corp.'s plan to make a "credit driven machine").

³⁴⁴ See JENSEN, *supra* note 258, at 42.

³⁴⁵ For example, at the Potawatomi Casino in Milwaukee, Wisconsin, patrons eighteen and over may play bingo; all other games are reserved for patrons twenty-one and over. The author gathered this info by calling the casino's toll-free telephone number, 1-800-PAYS-BIG.

³⁴⁶ See, e.g., Wisconsin Lottery, Frequently Asked Questions, <http://www.wilottery.com/faqreplies.asp?faqid=10> (last visited Apr. 2, 2006).

³⁴⁷ See 2000 Hearing on H.R. 3125, *supra* note 302, at 34 (statement of Kevin V. DiGregory, Deputy Assistant Att'y Gen., Criminal Division, U.S. Department of Justice) ("Currently, Internet gambling businesses have no reliable way of confirming that gamblers are not minors who have gained access to a credit card and are gambling on their websites.").

³⁴⁸ See Internet Gambling Licensing and Regulating Commission Act, H.R. 1223, 108th Cong. (2003).

³⁴⁹ See Gottfried, *supra* note 145, ¶ 38.

exclude minor players.³⁵⁰ Of course, anyone can enter through the front door of a casino. Any teenager who appears to be older may be able to play indefinitely in a casino before anyone asks the player's age.³⁵¹ To redeem vouchers or chips, some casinos require proof of age but may not ask for identification if the player does not look youthful.³⁵² In addition, a minor gambler can have a friend cash in his winnings for him. Interestingly, casinos seem less worried about children entering the casino and losing money than children entering the casino and winning money.

Arguably, gambling in a casino may be easier for some minors than gambling online. In a physical casino, a minor can bring in cash, obtained from whatever source. However, in an Internet casino, the minor will have to use a different financial product than cash. He will need a credit card or a debit card to use a website directly, or will have to purchase electronic cash or have a bank account from which money can be routed. Further, any winnings will be either credited to the card or the account or sent to the card or account holder's address.³⁵³ Therefore, if a minor attempts to use a parent's credit card or bank account information, all winnings will be sent to the parent.³⁵⁴ The average teenager may not have a credit card or bank account that a parent does not control or monitor.

For children under the age of eighteen who live at home, the Internet offers parents new tools for monitoring minors' gambling activities. Parents can install blockers that restrict minors' use of certain websites or use monitoring software that alerts parents of their children's gambling activities.³⁵⁵ Parents may find discovering evidence of online gambling easier than monitoring

³⁵⁰ See 2003 Hearing on H.R. 21 & H.R. 1223, *supra* note 286, at 10 (statement of John G. Malcolm, Deputy Assistant Att'y Gen., Criminal Division, U.S. Department of Justice) ("Unlike traditional physical casinos . . . the operators of gambling websites cannot look at their customers to assess their age and request photo identification.").

³⁵¹ See Habib, *supra* note 229, at 66 (pointing out that one underage college poker player was banned from Foxwoods casino only when he tried to purchase an alcoholic beverage and that one female player routinely gambled there with a fake ID).

³⁵² For example, Harrah's website states that "[a]ll Harrah's employees are trained to card individuals who appear to be below the age of 30." Harrah's Entertainment, Inc., Responsible Gaming, Project 21, http://www.harrahs.com/about_us/responsible_gaming/index.html#Project (last visited Apr. 2, 2006).

³⁵³ See Gottfried, *supra* note 145, ¶ 34.

³⁵⁴ *Id.*

³⁵⁵ One such blocking software product, GamBlock, is targeted specifically to problem gamblers. GamBlock, <http://www.gamblock.com> (last visited Apr. 2, 2006). Once the software is installed, all gaming sites are blocked and the software cannot be un-installed. GamBlock, Frequently Asked Questions, <http://www.gamblock.com>) (last visited Apr. 2, 2006) (follow "FAQ's" hyperlink). Other types of software are not targeted to gambling but merely allow parents to block certain sites and track activity. America Online provides this kind of service, called AOL® Guardian. America Online, Parental Controls, <http://discover.aol.com/aolfeatures.adp?d1=2&d2=4> (last visited Apr. 2, 2006).

activities outside the home, especially with driving-age teenagers.

Lastly, some opponents have even argued that allowing adults to gamble at home, where children can view the gambling, is dangerous and could lead to the children becoming problem gamblers.³⁵⁶ This argument, standing alone, is particularly unpersuasive given the panoply of behaviors that the United States does allow in an individual's home.³⁵⁷ A parent can subscribe to pornographic materials either in print or on the Internet, drink alcoholic beverages, and use tobacco products at home where minors are present, even though these activities are officially restricted to adults.

Admittedly, the ability to gamble over the Internet increases for minors over eighteen who live outside their parents' homes. Particularly for college students living away from home, with unlimited time and a credit card "for emergencies," all forms of gambling are quite tempting.³⁵⁸ Unfortunately, parents who pay off gambling debts may just be assisting their freshman gambler in continuing the activity. Although online gambling is a temptation for these underage individuals, it is but one of many temptations, and even only one of many gambling temptations.³⁵⁹ In addition, some gambling activities, such as bingo and the lottery, are legal for this age group.

To the extent that arguments about the welfare of minors are persuasive, they are more so when speaking of the eighteen- to twenty-year-olds who live independently from their parents and choose to gamble. This slice of the gambling population, however, which is allowed access to state-sponsored lotteries, may be insufficiently large to support an industry-wide prohibition.

b. *Increased Problem Gambling Increases Social Costs*

As gambling is introduced into a jurisdiction, the community may begin to suffer as social ills increase. By comparing U.S. counties where legalized casinos were introduced for the first time with counties without casinos during the same time period, studies have shown that counties in which casinos are introduced, and the counties that surround them, experience an increase in the

³⁵⁶ See Gottfried, *supra* note 145, ¶ 36.

³⁵⁷ Interestingly, one of the anti-Internet gambling bills introduced in the 106th Congress, the Internet Gambling Prohibition Act of 1999, H.R. 3125, 106th Cong. (1999), would have expanded existing law to allow U.S. residents to make wagers from their homes on horse races, dog races, and jai alai using a "closed-loop subscriber-based service." 2000 Hearing on H.R. 3125, *supra* note 302, at 35 (statement of Kevin V. DiGregory, Deputy Assistant Att'y Gen., Criminal Division, U.S. Department of Justice) (expressing concern to the Judiciary Committee that the bill was not supportable because it prohibited online gaming while allowing pari-mutuel betting over the Internet that is not currently allowable over the telephone).

³⁵⁸ See Habib, *supra* note 229, at 66 (profiling an Indiana University junior with an addiction to poker, both online and live, who gambled with cash advances from his friends' credit cards).

³⁵⁹ See *id.* (describing a regular live poker match at Yale's Trumbull residential college).

crime rate.³⁶⁰ One study estimated that the total cost of introducing a casino in a county was seventy-five dollars per adult given the increase in crime alone.³⁶¹ Other studies show an increase in bankruptcy rates coincident with the introduction of tribal casinos.³⁶² However, studies have failed to show an exact causal link between problem gambling and these crimes because of a lack of data on the reasons why crimes are committed.³⁶³ Even if we assume that the introduction of casino gambling increases problem gambling, which in turn leads to increases in bankruptcies, crime, and possibly divorce,³⁶⁴ opponents of Internet gambling would have to prove that gambling over the Internet would exacerbate the incidence of these negative externalities.³⁶⁵ The argument would have to prove that legalization of Internet gambling would increase the level of gambling generally and not that Internet gambling would displace existing casino customers.³⁶⁶ In addition, the level of problem gambling would have to increase as a result of the legalization of Internet gambling at a rate higher than problem gambling increases from the addition of traditional gambling opportunities.

c. *Money Laundering*

The rationale that Internet gambling websites create opportunities for money laundering and may be linked to organized crime is cited in both the “findings” section of all three unsuccessful anti-Internet gambling bills in the 108th Congress³⁶⁷ and in the U.S. government’s written arguments to the World

³⁶⁰ Kearney, *supra* note 48, at 286-87 (citing a 2004 study that compared all 3,165 U.S. counties for FBI Index 1 offenses: robbery, aggravated assault, rape, murder, larceny, burglary, and auto theft).

³⁶¹ *Id.* at 287 (“[R]oughly eight percent of crime in casino counties in 1996 was attributable to casinos, costing the average adult \$75 per year.”).

³⁶² *Id.* at 286 (describing a different study as finding that in counties where tribal casinos were introduced, bankruptcy rates and violent crime increased ten percent); see Person Liddell et al., *Internet Gambling: On a Roll?*, 28 SETON HALL LEGIS. J. 315, 337 (2004) (citing a 1997 study that found that gambling was the third leading cause of bankruptcies).

³⁶³ See Kearney, *supra* note 48, at 278 (discussing how pathological gamblers often have other behavioral disorders, thus making it difficult to establish a causal link).

³⁶⁴ ROSE & OWENS, *supra* note 33, at 139 (citing as the greatest threat to legal gambling increased incidents of “suicide, divorce, loss of jobs, and imprisonment”).

³⁶⁵ See Binyamin Appelbaum, *Old Games, New Twist*, CHARLOTTE OBSERVER, May, 16, 2005, at D1 (quoting Keith Whyte, executive director of National Council of Problem Gambling, as saying that because of the information potential of the Internet, “online gambling has the potential to be safer than casino gambling”).

³⁶⁶ See Kearney, *supra* note 48, at 288 (positing that Internet gambling might “cannibalize” state lottery sales and casino revenue).

³⁶⁷ See, e.g., S. 627, 108th Cong. § 2(4) (2003) (“Congress finds that . . . (4) Internet gambling conducted through offshore jurisdictions has been identified by United States law enforcement officials as a significant money laundering vulnerability. . . .”).

Trade Organization (WTO) defending its anti-Internet gambling stance.³⁶⁸ As argued below, these concerns exist with any type of electronic commerce.

Arguably, Internet gambling provides an easy forum for money laundering by allowing criminals to place ill-gotten gains into remote accounts, gamble a negligible amount, and then have their account balances mailed to them as legal “winnings.”³⁶⁹ Because traditional casinos, like banks, handle large amounts of cash and offer an array of credit services to gamblers, arguments connecting money laundering to gambling pre-date Internet gambling and have proved to hold true for physical casino gambling.³⁷⁰ To curb this potential for abuse, the federal government included casinos as “financial institutions” that must follow regulations under the Bank Secrecy Act³⁷¹ and report the name and social security number of all patrons who, within a twenty-four-hour period, spend a total of \$10,000 or more in cash or receive \$2,500 or more in cash as an extension of credit.³⁷²

Because remote gaming websites also handle monetary transactions and, moreover, are out of the reach of U.S. banking regulators,³⁷³ the same money laundering that occurs in physical casinos may also take place in the accounts of an online casino. Ironically, by pressuring the U.S. credit card industry to abandon the Internet gambling market to foreign banks and electronic cash services companies, the U.S. government has made it easier for money to be laundered through the many necessary layers involved in getting U.S. cash to

³⁶⁸ Panel Report, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/R (Nov. 10, 2004), available at 2004 WL 2650633, at *77 [hereinafter “Panel Report”] (“The United States has provided evidence showing that US law enforcement authorities have seen organized crime playing a growing role in Internet gambling.”).

³⁶⁹ NGISC REPORT, *supra* note 15, at 5-6.

³⁷⁰ See 2003 Hearing on H.R. 21 & H.R. 1223, *supra* note 286, at 11 (statement of John G. Malcolm, Deputy Assistant Att’y Gen., Criminal Division, U.S. Department of Justice) (stating that criminals have turned from laundering money through banks to casinos, which offer “credit accounts, fund transmittal services, check cashing services, and currency exchange services”). *But see* ROSE & LOEB, *supra* note 53, at 105-06 (arguing that the “war” on drugs was a pretextual excuse for including casinos in the Bank Secrecy Act and that the true rationale behind the gaming focus was a desire to track gamblers for income tax purposes).

³⁷¹ Bank Records and Foreign Transactions Act, Pub. L. No. 91-508, 84 Stat. 1114 (1984); Casino Regulations, 50 Fed. Reg. 5065, 5065 (Feb. 6, 1985) (amending 31 C.F.R. pt. 103 “to include gambling casinos in the definition of financial institution”).

³⁷² ROSE & LOEB, *supra* note 53, at 102-03.

³⁷³ See 2003 Hearing on H.R. 21 & H.R. 1223, *supra* note 286, at 11 (statement of John G. Malcolm, Deputy Assistant Att’y Gen., Criminal Division, U.S. Department of Justice): On-line casinos are a particularly inviting target because, in addition to using the gambling that on-line casinos offer as a way to hide or transfer money, on-line casinos offer a broad array of financial services to their customers, such as providing credit accounts, fund transmittal services, check cashing services, and currency exchange services.

an offshore gaming website.³⁷⁴ Anti-Internet gambling opponents seem to base their arguments on the fact that many remote gambling websites are hosted by smaller countries with regulatory schemes that are unknown to the U.S. government, such as Antigua and Gibraltar.³⁷⁵ As the government of Antigua pointed out to the WTO, the U.S. government does not cite to any investigation or case involving Internet gambling and money laundering.³⁷⁶ In fact, the Financial Action Task Force and the Caribbean Financial Action Task Force have found no evidence of money laundering in Antigua.³⁷⁷ In addition, many popular gaming websites are hosted by the United Kingdom and Australia, countries that have instituted rigorous regulatory schemes for online gambling.³⁷⁸ The money laundering concerns expressed by the U.S. government are concerns about electronic commerce over the Internet and would be equally applicable to any commercial website located outside the United States.

d. *Fraud*

A related concern is that these gaming websites may be unfairly presenting games to players with much lower odds than advertised or expected.³⁷⁹ Most games on remote websites do not operate entirely by chance, but by algorithms meant to simulate chance in an electronic format.³⁸⁰ For example, slot machines on a gaming website virtually spin and then stop in a computer-generated manner, not by physically spinning rotary wheels that stop via the laws of physics. Opponents argue that these algorithms are unknowable to players and regulators and could be designed to produce no winners or fewer winners than would be expected or that is advertised.³⁸¹ However, most slot

³⁷⁴ Susan Ormond, *Pending U.S. Legislation to Prohibit Offshore Internet Gambling May Proliferate Money Laundering*, 10 L. & BUS. REV. AM. 447, 451-54 (2004).

³⁷⁵ See Panel Report, *supra* note 368, at *16 (“The United States submits that Antigua’s attempts to regulate gambling and money laundering cannot address basic concerns relating to remote supply of gambling.”).

³⁷⁶ *Id.* at *72.

³⁷⁷ *Id.* (pointing out that in 1999 the United States itself lifted a “Financial Advisory” in relation to money laundering that it had previously imposed on Antigua and Barbuda).

³⁷⁸ ROSE & OWENS, *supra* note 33, at 197, 197-200 (describing the “first comprehensive system for licensing and regulating Internet gambling” developed by New Zealand and then adopted by other British commonwealth countries, including England and Australia).

³⁷⁹ See Panel Report, *supra* note 368, at *14, *73 (outlining the various types of frauds that can be perpetrated by “criminal firms” and quoting the United States as alleging that the “potential for fraud is heightened when gambling opportunities are supplied from remote locations”).

³⁸⁰ *Id.* at *63.

³⁸¹ See *id.* at *78 (criticizing Antigua for ignoring “the inherent manipulability of Internet gambling,” pointing to the NGISC’s claim that “the global dispersion of Internet gambling operations makes the vigilant regulation of the algorithms of Internet games nearly impossible”).

machines in casinos are not manually operated slot machines either.³⁸² Electronic gaming devices featuring video poker have the same game integrity problems as an online poker game. Opponents argue that even though EGDs and electronic slot machines in the United States are equally as susceptible to corrupt programming, these machines are subject to U.S. regulation and oversight.³⁸³ However, most casino operators and EGD websites are loosely supervised and subject only to self-reporting of errors.³⁸⁴

Other technologies may allow colluding gamblers to cheat on group poker websites. If three friends join in a hand of Texas Hold'em against one stranger on the Internet, the three friends, either physically together in a computer lab, in a laptop huddle, or in communication via Instant Messenger or cell phone, can collude.³⁸⁵ This is a particular vulnerability of one online game, and one that many players are able to detect and avoid by exiting the game. In addition, websites claim to monitor for this type of fraud.³⁸⁶

These arguments for prohibition of online gambling ignore the fact that a market exists for Internet gambling and that websites seek to attract gamblers by presenting themselves as sound institutions. For example, PriceWaterhouseCoopers (PWC) audits online websites and provides a PWC stamp of approval.³⁸⁷ If Internet gaming were regulated, U.S. firms could dominate the market with websites with internal controls as strict as those in physical casinos, if not stricter. Through branding and market influence, rational consumers would then have safe Internet gambling options.³⁸⁸ In the

³⁸² JENSEN, *supra* note 258, at 15-17 (explaining that although some slots have spinning reels, they are controlled by a computer; others are electronic games that simulate spinning reels on a video screen).

³⁸³ *See id.* at 125 (describing how slot machines are controlled by a computer chip that is set by a factory mechanic while being supervised by a gaming commission agent).

³⁸⁴ *See* NGISC REPORT, *supra* note 15, at 3-6 ("State regulators often rely upon the casinos to maintain logs that document irregularities and to 'self-report' violations.").

³⁸⁵ *See* Steven E. Hurdle, Jr., Note, *Cyberbust: The Elimination of Gambling on the Internet*, 2004 UCLA J.L. & TECH. 4 (2004) (describing the mechanics of "electronic cheating").

³⁸⁶ *See, e.g.,* Party Poker, Game Fairness, http://www.partypoker.com/about_us/game_fairness (last visited Apr. 2, 2006) ("Our collusion prevention system detects fraud patterns and identifies colluders.").

³⁸⁷ Appelbaum, *supra* note 365, at D1 (indicating that several consumer websites and chat rooms contain quality information on gambling sites and that PWC offers a certification program to "[s]everal dozen" casinos).

³⁸⁸ *See* Liddell, *supra* note 362, at 349-50 (explaining that "[b]rand recognition leads to source credibility"). The MGM Mirage entered the offshore casino market but folded out of fear of losing its Nevada license. Woellert, *supra* note 296, at 67. At one time, the major U.S. casinos each had plans for online gambling sites that would hopefully have a spillover effect for their physical sites. Liz Benston, *WPT Launches New Internet Poker Room*, LAS VEGAS SUN, June 29, 2005, at C3 (giving as examples casinos such as MGM Mirage, Harrah's Entertainment Inc., and Las Vegas Sands Corp.); *see 60 Minutes* (CBS television

United Kingdom and Australia, for example, online companies go through rigorous licensing procedures.³⁸⁹

Allegations of fraud have not escaped traditional gambling, either. Professional blackjack players concede that human dealers can cheat players easily with sleight of hand dealing of the second card in the deck, using uneven decks, heavy with low cards, or preferential shuffling.³⁹⁰

Online sites that accept credit card or some type of electronic transfer may also be able to defraud gamblers by making unauthorized transfers.³⁹¹ Hacking from outsiders may also be a risk; however, there is no evidence that online gaming sites have less interest in keeping out hackers than any other online business. Proponents of online gambling point out that fears of fraud and privacy breaches are concerns inherent in electronic payment systems, particularly foreign electronic payment systems, and are not specific to Internet gaming.³⁹² The best way to protect gambling consumers would be to regulate Internet gaming, allow U.S. websites and payment systems to re-enter the market, and extend the requirements of the Bank Secrecy Act to online gaming sites.³⁹³

Other commentators have noted that in comparing online gambling with physical gambling sites in the United States, the opponents of online gambling are comparing an industry that is highly regulated by the United States to an illegal industry that is unregulated.³⁹⁴ The conclusion from that comparison need not be to continue to prohibit online gambling and create more barriers to

broadcast Nov. 20, 2005) (quoting the CEO of MGM Mirage as saying that allowing Internet gambling would double the revenue of that company). However, these casinos abandoned their plans after anti-gambling bills in the 108th Congress seemed to gain momentum. See Caroline Bissett, *All Bets Are Off(ine): Antigua's Trouble in Virtual Paradise*, 35 U. MIAMI INTER-AM. L. REV. 367, 377-78 (2004) (describing how MGM Mirage Online "closed its site one week before the House vote with a \$5 million dollar loss due to the elimination of U.S. gamblers from its market").

³⁸⁹ ROSE & OWENS, *supra* note 33, at 197-200.

³⁹⁰ See ROSE & LOEB, *supra* note 53, at 65-67 ("Complaints about altering the deck with extra small cards or removing high cards persist within the blackjack publications and Internet sites. Although objective confirmation of such reports are rare, their numbers suggest that the practice endures."); see also *Zaika v. Del Webb Corp.*, 508 F. Supp. 1005, 1005 (D. Nev. 1981) (alleging that plaintiff's blackjack losses were the result of an extra card put in the deck by the casino).

³⁹¹ 2000 Hearing on H.R. 3125, *supra* note 302, at 34 (statement of Kevin V. DiGregory, Deputy Assistant Att'y Gen., Criminal Division, U.S. Department of Justice) ("Fraudulent activities can range from credit card fraud to the manipulation of gambling odds.").

³⁹² See Liddell, *supra* note 362, at 349-51 (analogizing a hypothetical world with legal, regulated online casinos to the current reality of securely shopping at Sears.com).

³⁹³ Gottfried, *supra* note 145, ¶ 25 (advocating the extension of the Bank Secrecy Act to Internet gambling sites to "help create the audit trails useful to law enforcement agents in tracking money launderers").

³⁹⁴ See *id.* ¶ 13; see *supra* note 289 and accompanying text.

participation. Instead, the U.S. government could create a regulatory regime for online gambling that would enhance protections against money laundering and fraud.

VI. GOVERNMENTAL RESPONSE TO INTERNET GAMBLING

A. *U.S. Enforcement of Anti-Gambling Laws Against Internet Gambling Sites*

Although the U.S. government asserts that the Wire Communications Act applies to all online betting, not just sports betting, most prosecutions of remote gaming sites have involved sports betting. The most publicized prosecution for violating the Wire Communications Act by maintaining an offshore betting website focused on Jay Cohen, whose conviction was upheld by the Second Circuit in *United States v. Cohen*.³⁹⁵ Cohen, a former securities trader, had started a bookmaking enterprise, World Sports Exchange (WSE), in Antigua with other Americans.³⁹⁶ Customers in the United States would wire money to a WSE account in Antigua and then place sports bets either by telephone or by Internet.³⁹⁷ Cohen appealed his conviction and twenty-one-month sentence on several grounds, including that the rule of lenity required his conviction to be reversed.³⁹⁸ Under this due process concept, his conviction could be reversed if a statute was being applied in a novel way that no defendant could have predicted given the statutory text and existing case law.³⁹⁹ The Second Circuit rejected that argument.⁴⁰⁰ At the same time that Cohen was indicted, twenty-one other defendants involved in offshore bookmaking were charged with violations of the Wire Act.⁴⁰¹

Other reported prosecutions of Internet gambling have been sparse. Prior to *Cohen*, the State of New York had successfully prosecuted World Interactive Gaming Corporation in its jurisdiction under both state law and the Wire Act.

³⁹⁵ 260 F.3d 68 (2d Cir. 2001).

³⁹⁶ *Id.* at 70.

³⁹⁷ *Id.*

³⁹⁸ *Id.* at 76 (detailing Cohen's argument that the Wire Act is "too unclear to provide fair warning of what conduct it prohibits").

³⁹⁹ *Id.*

⁴⁰⁰ *Id.* at 76-77.

⁴⁰¹ See Press Release, U.S. Dept. of Justice, Jay Cohen Convicted of Operating an Off-Shore Sports Betting Business that Accepted Bets from Americans over the Internet (Feb. 28, 2000), available at <http://www.usdoj.gov/criminal/cybercrime/cohen.htm> (detailing that "[t]en of those defendants subsequently plead guilty . . . three plead guilty to related misdemeanor counts; and seven . . . remain as fugitives"). Notably, WSE remains in business and is one of the largest online sports casinos. See Sheckel Masoud, *The Offshore Quandary: The Impact of Domestic Regulation on Licensed Offshore Gambling Companies*, 25 WHITTIER L. REV. 989, 997 (2004) (remarking that the court's decision had a "negligible impact" on WSE).

In that case, *People v. World Interactive Gaming Corp.*,⁴⁰² the state court had unhesitatingly applied the Wire Communications Act to non-sports casino gambling, even though the DOJ stated at the time that some ambiguity existed as to that applicability.⁴⁰³ Most recently, the federal government in 2001 and 2002 indicted several Americans, their accountants, and their attorneys for conspiracy to violate the Wire Communications Act and conspiracy to commit money laundering in connection with Gold Medal Sports, an offshore bookmaking website located on the island of Curacao.⁴⁰⁴ The two main owners pled guilty to violating the Wire Communications Act and falsifying income tax returns and were sentenced to five years in prison.⁴⁰⁵

B. *Recent Legislative Attempts to Prohibit Internet Gambling*

In 1996, Congress assembled the National Gambling Impact Study Commission to “conduct a comprehensive legal and factual study of the social and economic impacts of gambling in the United States,”⁴⁰⁶ including “the use of interactive technologies and the Internet.”⁴⁰⁷ The NGISC issued its final report on June 18, 1999, in which the commission recommended that the federal government take further steps to prohibit Internet gambling.⁴⁰⁸ Following the issuance of that report, numerous bills have been introduced in Congress that would specifically criminalize some aspect of Internet gambling, from hosting and participating to providing financial payment mechanisms and advertising.⁴⁰⁹ Although the DOJ takes the official position that Internet

⁴⁰² 714 N.Y.S.2d 844, 865 (N.Y. Sup. Ct. 1999) (holding that a Delaware corporation that owned an Antiguan subsidiary that operated an online casino had violated both New York state law and federal law).

⁴⁰³ *Id.* at 862.

⁴⁰⁴ Press Release, U.S. Dept. of Justice, Florida Lawyer Charged in Offshore Sports Betting Case (Oct. 22, 2002), *available at* <http://www.usdoj.gov/criminal/cybercrime/tedderIndict.htm> (“The indictment caps a three-year undercover and financial investigation conducted by federal authorities into illegal offshore sports bookmaking.”).

⁴⁰⁵ *Id.*

⁴⁰⁶ National Gambling Impact Study Commission Act, Pub. L. No. 104-169, § 4(a)(1), 110 Stat. 1482, 1484 (1996).

⁴⁰⁷ *Id.* § 4(a)(2)(F).

⁴⁰⁸ NGISC REPORT, *supra* note 15, at 5-12 (recommending the development of “enforcement strategies that include, but are not limited to, Internet service providers, credit card providers, money transfer agencies, makers of wireless communications systems, and others who intentionally or unintentionally facilitate Internet gambling transactions”).

⁴⁰⁹ In the 106th Congress, a flurry of bills were introduced to implement the recommendations of the NGISC. *See, e.g.*, Unlawful Internet Gambling Funding Prohibition Act, H.R. 4419, 106th Cong. (2000) (introduced by Rep. Leach); Internet Gambling Prohibition Act of 1999, S. 692, 106th Cong. (1999) (introduced by Sen. Kyl). Although none of these bills were signed into law, similar bills were introduced in the 107th Congress. *See, e.g.*, Internet Gambling Payments Prohibition Act, H.R. 2579, 107th Cong.

gambling is illegal under existing law,⁴¹⁰ these bills have sought to clarify any ambiguity in the Wire Act and to focus on collateral activity that facilitates the online gaming industry.

In the 108th Congress, one bill was introduced in the Senate under the title “Internet Gambling Funding Prohibition Act”⁴¹¹ and two bills were introduced in the House of Representatives, both with the title “Unlawful Internet Gambling Prohibition Act.”⁴¹² All three substantially identical bills⁴¹³ sought to prohibit the use of credit cards issued by U.S. financial institutions by users of Internet gambling. One such bill, H.R. 2143, detailed new electronic funding procedures, to be monitored by a new Office of Electronic Funding Oversight, which would require financial institutions to develop and implement policies and procedures “reasonably designed to identify . . . and . . . block . . . or . . . prevent” the extension of credit for purposes of Internet gambling.⁴¹⁴ Interestingly, the bill exempted from prohibition the use of electronic credit over the Internet to make otherwise legal interstate or intrastate bets or wagers on live horse and live dog racing.⁴¹⁵ None of these bills was passed by both houses before the end of the 108th Congress.

Notably, one competing bill was introduced in the 108th Congress that proposed creating an Internet Gambling Licensing and Regulation Study Commission to consider regulating Internet gambling.⁴¹⁶ The findings of H.R. 1223 contained the reasoning that “[b]ecause of the nature of the Internet, legislative attempts to prohibit Internet gambling are unlikely to be effective, and may adversely impact American’s [sic] rights to due process and individual privacy.”⁴¹⁷ The Department of Justice opposed this bill, taking the

(2001) (introduced by Rep. LaFalce); Unlawful Internet Gambling Funding Prohibition Act, H.R. 556, 107th Cong. (2001) (introduced by Rep. Leach).

⁴¹⁰ Letter from Jon P. Jennings, *supra* note 290 (urging the Judiciary Committee not to introduce new anti-gambling legislation, but instead to amend the Wire Act to clarify that it prohibits all bets and wagers, not just sports-related bets and wagers, over the Internet, telephone, or other wireless communications facility).

⁴¹¹ S. 627, 108th Cong. (2003) (introduced by Sen. Kyl).

⁴¹² H.R. 21, 108th Cong. (2003) (introduced by Rep. Leach); H.R. 2143, 108th Cong. (2003) (introduced by Rep. Bachus).

⁴¹³ The findings for H.R. 21 and H.R. 2143 cited as reasons for regulation “debt collection problems for insured depository institutions and the consumer credit industry” and “significant money laundering vulnerability.” H.R. 21 § 2(3) & (4); H.R. 2143 § 2(3) & (4). *But see* S. 627 § 2 (adding § 5, which warned of the “possibility of immediate, individual, 24-hour access in every home to the full range of wagering opportunities on sporting events or casino-like contests”).

⁴¹⁴ H.R. 2143 § 3(b)(1).

⁴¹⁵ *Id.* § 4(1) (limiting the bill’s reach to “restricted transactions,” defined as transactions in connection with “unlawful Internet gambling,” not Internet gambling currently allowed).

⁴¹⁶ Internet Gambling Licensing and Regulation Commission Act, H.R. 1223, 108th Cong. (2003) (introduced by Rep. Conyers).

⁴¹⁷ *See id.* § 2(9).

position that regulation, not prohibition, was not feasible, and that the only way to protect American consumers was to prohibit Internet gambling.⁴¹⁸

A brief pause in legislative action coincided with efforts by the country of Antigua and Barbuda to demonstrate to the World Trade Organization that the cumulative effect of U.S. laws was to prohibit Internet gambling sites located in that country from doing business in the United States in violation of U.S. commitments under the General Agreement on Trade in Service (GATS).⁴¹⁹ Perhaps legislators were awaiting the outcome of the ruling, described below,⁴²⁰ which became final in April 2005.⁴²¹ On February 16, 2006, a new bill was introduced in the House of Representatives with the title "Internet Gambling Prohibition Act."⁴²² Interestingly, the bill has 115 co-sponsors.⁴²³

C. *Leveraging Financial Institutions and the Media to Prohibit Internet Gambling*

Although federal lawmakers have been unable to pass new legislation clarifying that federal laws prohibit Internet gambling, prosecutors have turned their attention from gambling establishments and gamblers to the legitimate businesses that facilitate Internet gambling: financial institutions and members of the advertising industry. For a gambler to be able to make a wager over the Internet on an offshore site, he must first find the site and then find a way to get money from the United States to that website's host. Recently, prosecutors have decided to frustrate gambler's access to online gambling by focusing on these two necessary conditions to Internet play.

Federal and state prosecutors,⁴²⁴ including New York Attorney General Eliot Spitzer,⁴²⁵ threatened financial institutions with various crimes for

⁴¹⁸ 2003 Hearing on H.R. 21 & H.R. 1223, *supra* note 286, at 11 (statement of John G. Malcolm, Deputy Assistant Att'y Gen., Criminal Division, U.S. Department of Justice) ("[T]he Department believes that Internet gambling should be prohibited . . .").

⁴¹⁹ See Request for the Establishment of a Panel by Antigua and Barbuda, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/2 (June 13, 2003), available at 2003 WL 2138159 [hereinafter "Antigua Panel Request"].

⁴²⁰ See *infra* Part VI.D.

⁴²¹ See Appellate Body Report, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/AB/R (April 7, 2005), available at 2005 WL 852159 [hereinafter "Appellate Report"].

⁴²² H.R. 4777, 109th Cong. (2006).

⁴²³ *Id.*

⁴²⁴ For example, the State of Oregon has passed a law making the acceptance of credit cards, electronic funds transfers, or checks by an online gambling business a Class C felony. OR. REV. STAT. § 167.109 (2003).

⁴²⁵ See Manter, *supra* note 308, ¶ 8 (describing how Spitzer threatened Citibank with prosecution for "knowingly profiting from an illegal activity" before Citibank agreed not to allow gambling charges and to donate \$400,000 to compulsive gambler counseling services).

facilitating Internet gambling, including violating the Patriot Act, which prohibits transferring money known to be connected to criminal activity, prompting financial institutions to change their own policies. After paying ten million dollars in forfeiture payments to the DOJ⁴²⁶ and two hundred thousand dollars to settle a parallel investigation brought by Spitzer, PayPal, which was bought by eBay, agreed to abandon the lucrative Internet gaming business.⁴²⁷ PayPal, which offers electronic payment services tied to a credit card or bank account, continues to dominate the online auction industry, but other non-U.S. companies have stepped in to fill the gambling void, most notably Neteller.⁴²⁸ PartyGaming, the U.K. gambling website that went public in 2005, has its own in-house electronic payment system.⁴²⁹

Following the PayPal settlement, some banks that issue MasterCard and Visa cards also agreed to disallow payments to offshore gambling sites.⁴³⁰ In addition, Discover and American Express have agreed to disallow these charges as well.⁴³¹ However, most online gaming sites prominently display MasterCard and Visa signs to reflect the continuing availability of those forms of payment.⁴³² As long as the card is not issued by one of the few, mostly large, merchant banks that will decline the payment, the card will be accepted.⁴³³ In fact, many sites continued to claim to also accept PayPal, even after PayPal withdrew from the market.⁴³⁴

The Department of Justice also turned its attention to advertisers and advertising agencies in 2004, sending a letter to members of the National Association of Broadcasters threatening media outlets that accepted advertising from offshore gambling websites with prosecution for aiding and abetting

⁴²⁶ *In re PayPal, Inc.* (E.D. Mo. July 24, 2003) (on file with author).

⁴²⁷ Woellert, *supra* note 296, at 67.

⁴²⁸ See Maija Pesola, *Neteller is Seeking a Banking Venture*, FIN. TIMES, Apr. 6, 2005, at 24 (reporting that Neteller opens 2,700 new customer accounts per day).

⁴²⁹ Spencer E. Ante, *Looks Like a Sure Thing, but . . .*, BUS. WK., July 4, 2005, at 41; see *supra* notes 299-300 and accompanying text.

⁴³⁰ See Komando, *supra* note 297, at 63 (pointing out that Chicago-based BankOne declines such credit card transactions); see also Parke & Griffiths, *supra* note 321, at 296-97 (describing the two-tier system in which individual merchant banks that issue these cards are ultimately responsible for monitoring and enforcing stated policies that these cards may only be used for legal transactions).

⁴³¹ *Peer-to-Peer Gaming Coming Soon to America*, TECHWEBNEWS, July 7, 2004, <http://internetweek.cmp.com/showArticle.jhtml?articleID=22104153>.

⁴³² Parke & Griffiths, *supra* note 321, at 297-98 (commenting that the USGAO reports that eighty-five percent of online gaming sites conspicuously claim to accept Visa and MasterCard credit cards, but that some of those claims rely on the fact that a U.S. resident can use the cards to open accounts at electronic payment systems such as NETeller).

⁴³³ *Id.*

⁴³⁴ *Id.* at 298 (citing the USGAO report that two-thirds of online gaming sites continue to advertise PayPal as an accepted payment aggregator).

violations of the Wire Act.⁴³⁵ Newspapers and magazines that had routinely sold advertising to online casinos for years were issued subpoenas and threatened with prosecution unless they stopped immediately.⁴³⁶ Ironically, Discovery Communications, whose Travel Channel was airing the World Poker Tour from the Bellagio casino in Las Vegas, was threatened with felony prosecution and had \$3.2 million seized by federal marshals not for nationally broadcasting an event that is illegal in many states, but for planning on running ads during the event for online casinos, which are illegal in all states but legal abroad.⁴³⁷ After Discovery pulled the lucrative ads, Infinity Broadcasting and Clear Channel Communications pulled all radio ads for online gambling.⁴³⁸ Currently, most U.S. print and broadcast outlets refuse to accept online gambling ads if they will be seen in the United States.⁴³⁹ In addition, Google, Yahoo, and Lycos have stopped selling ad space to gaming websites.⁴⁴⁰

Notably, these practices may also run afoul of WTO commitments. For example, if the United States allows credit cards to be used at U.S. gambling establishments but not at offshore gambling websites, then other countries may again argue that the United States is discriminating against foreign suppliers of gambling products not to protect public morals, but to protect its own gambling industry.⁴⁴¹ Perhaps because of attention from the WTO, the DOJ has been

⁴³⁵ See *Casino City, Inc. v. U.S. Dep't of Justice*, No. 04-557-B-M3, slip op. at 7 (M.D. La. Feb. 15, 2005) (granting the DOJ's motion to dismiss for lack of standing against the plaintiff's claim that the DOJ's threatened action would violate the First Amendment). Some states employed the same tactics. During 1998 and 1999, the Florida Attorney General sent cease and desist letters to ten advertising companies that represented online casinos. Walters, *supra* note 295, at 447.

⁴³⁶ See Woellert, *supra* note 296, at 66 (describing the investigation of the publisher of Pro Football Weekly, a popular Chicago trade paper that had run the ads for decades, and the publisher's subsequent decision to pull the ads).

⁴³⁷ Megan Fiese, Note, *Rolling the Dice: Are Online Gambling Advertisers "Aiding and Abetting" Criminal Activity or Exercising First Amendment-Protected Commercial Speech?*, 15 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 547, 555 (2005).

⁴³⁸ *Id.*

⁴³⁹ See David Kesmodel, *Internet Casinos Get Creative With Ads*, WALL ST. J., Mar. 2, 2005, at B2 (stating that online casinos have had to resort to alternative methods of advertising in light of media outlets rejecting their advertising). *Casino City, Inc.*, a small gambling information website that had previously accepted ads for gambling sites, filed a complaint against the DOJ in the Middle District of Louisiana seeking a declaratory judgment that the DOJ's stance ran afoul of the First Amendment. The Middle District held that *Casino City* did not have standing because the company had not itself received a letter and was under no threat of prosecution. *Casino City*, No. 04-557-B-M3, slip op. at 7. *Casino City* has appealed to the Fifth Circuit. *Casino City, Inc. v. U.S. Dep't of Justice*, No. 04-557-B-M3 (Apr. 12, 2005) (notice of appeal). Notably, the Fifth Circuit is the one circuit that has previously held that nonsports online gambling is not illegal under federal law. *In re Mastercard Int'l Inc. Internet Gambling Litig.*, 313 F.3d 257, 263 (5th Cir. 2002).

⁴⁴⁰ Kearney, *supra* note 48, at 298.

⁴⁴¹ See discussion of U.S. WTO obligations, *supra* Part V.B.1.c.

silent on online gaming advertising in the past year.⁴⁴²

D. *International Response to U.S. Efforts to Prohibit Internet Gambling*

In Spring 2003, Antigua and Barbuda complained to the World Trade Organization that the laws of the U.S. government, read in conjunction with the anti-gambling laws of several states, amounted to a prohibition of foreign online gaming providers in contravention of the General Agreement on Trade in Service (GATS). When a requested “consultation”⁴⁴³ did not result in an understanding, the Caribbean country requested that a panel be organized to hear the dispute.⁴⁴⁴ The Dispute Settlement Panel’s report found that the United States was in violation of its GATS commitments by prohibiting Internet gambling provided by offshore suppliers.⁴⁴⁵ The United States appealed that finding, and unfortunately the resulting report by the Appellate Body⁴⁴⁶ is less than clear.

The Panel had concluded that the laws of the United States, including the Wire Act, the Travel Act, and the Illegal Gambling Business Act, as well as the laws of Louisiana, Massachusetts, South Dakota, and Utah, had the cumulative effect of prohibiting the delivery of gambling and betting services from foreign suppliers in contravention of its GATS commitments.⁴⁴⁷ The Panel found that the United States had made commitments regarding gambling and betting services and as such had to “accord services and service suppliers of Antigua treatment no less favourable than that provided for under the terms” of that agreement.⁴⁴⁸ The United States had argued that it was allowed to prohibit Internet gambling out of necessity to ensure public morals and public order, namely to protect against money laundering, fraud, underage gambling, and

⁴⁴² See Kesmodel, *supra* note 439, at B2 (quoting one attorney for offshore Internet casinos as saying, “The bottom line here is the supposed crackdown [by the Justice department] never happened.”).

⁴⁴³ Request for Consultations by Antigua and Barbuda, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/1 (Mar. 27, 2003), available at 2003 WL 1697761; Request for Consultations by Antigua and Barbuda, addendum, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/1/Add.1 (Apr. 10, 2003), available at 2003 WL 1854666.

⁴⁴⁴ Antigua Panel Request, *supra* note 419, at 2 (requesting the Dispute Settlement Body to establish a panel to examine whether the United States’ “total prohibition of gambling and betting services offered from outside the United States” conflicts “with the United States’ obligations under GATS and its Schedule of Specific Commitments”).

⁴⁴⁵ Panel Report, *supra* note 368, at 273.

⁴⁴⁶ Appellate Report, *supra* note 421, at 123-26.

⁴⁴⁷ Panel Report, *supra* note 368, at 272 (finding not only that the United States had made specific commitments regarding “gambling and betting services,” but also that its stated reason for exception – public morals and public safety – was not justified).

⁴⁴⁸ *Id.*

organized crime.⁴⁴⁹ However, to use this exception to its GATS commitments, the U.S. government would have to show that the laws in question did not act in an arbitrary or discriminatory way.⁴⁵⁰ Specifically, the Panel did not believe that the United States applied its prohibition on the remote supply of gambling services in a nondiscriminatory manner because, among other things, the United States allows for gambling over the Internet for horse racing and dog racing at various domestic locations.⁴⁵¹

The Appellate Body narrowed the opinion of the original panel, but retained the specific finding that

the United States has not shown, in the light of the Interstate Horseracing Act, that the prohibitions embodied in those measures are applied to both foreign and domestic service suppliers of remote betting services for horse racing and, therefore, has not established that these measures satisfy the requirements of the chapeau.⁴⁵²

Both sides claimed victory. The United States stated that the Appellate Body had vindicated the right of the U.S. government to prohibit Internet gaming.⁴⁵³ Although the Appellate Body had ordered the United States to harmonize its horse racing laws with its WTO commitments, some reports stated that the U.S. government took the position that it did not have to alter its current laws at all.⁴⁵⁴ However, the government of Antigua also pronounced

⁴⁴⁹ *Id.* at 64 (stating as the primary United States public safety concerns “(i) the risk of under age gambling; (ii) the risk of increased pathological gambling; (iii) the risk of abuse of non-domestic service providers for money laundering purposes; and (iv) the heightened risk of crime, fraud and related consumer protection issues”). Under Article XIV(a), a country may be granted an exception for laws that are “necessary to protect public morals or to maintain public order.” *Id.* at 108.

⁴⁵⁰ *Id.* at 241. Article XIV requires that the measure that is to be justified under the public morality and public order exception may not be “applied in a manner which would constitute a means of arbitrary and unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services.” *Id.* at 112.

⁴⁵¹ *Id.* at 271:

[O]n the basis of evidence provided to the Panel relating to the domestic enforcement of the US prohibition on the remote supply of wagering services for horse racing . . . and in light of the ambiguity relating to the Interstate Horseracing Act . . . we believe that the United States has not demonstrated that it applies its prohibition on the remote supply of these services in a consistent manner as between those supplied domestically and those that are supplied from other Members.

⁴⁵² Appellate Report, *supra* note 421, at 126.

⁴⁵³ See Paul Bluestein, *U.S. Claims Victory on Web Betting Ban*, WASH. POST, Apr. 8, 2005, at E4 (citing the acting U.S. trade representative, Peter F. Allgeier, as saying that the United States would be in compliance with WTO rules after it “‘clarifies’ certain Internet gambling restrictions”).

⁴⁵⁴ See Liz Benston, *WTO Ruling Provides Scope for U.S. Online Gambling Ban*, LAS VEGAS SUN, Apr. 7, 2005, at C1 (stating that as a result of winning “key arguments before the WTO . . . the U.S. Trade Representative said it won’t ask Congress to weaken restrictions on online betting”).

victory,⁴⁵⁵ and predicted that these proceedings would chill any further restrictions by the U.S. government, including any new proposals to criminalize the use of credit cards for Internet gambling.⁴⁵⁶ Unfortunately, the murky legal environment of Internet gambling was not made much clearer by the WTO proceedings. However, the proceedings did clarify certain points for the future, including the foundational fact that the WTO takes the position that the U.S. government has made GATS commitments regarding gambling services.⁴⁵⁷ In addition, the WTO proceedings do reflect that the WTO takes cross-border provision of gambling services very seriously and will not hesitate to examine carefully both the text of current laws, the operation and effect of current laws, and the motivations behind them.

VII. HARMONIZING THE REGULATION OF INTERNET SPECULATION

As discussed in Part III, similar forms of speculation are not regulated consistently. Wagering activities traditionally labeled as gambling are restricted far more than similar wagering activities traditionally labeled as investing, even though the costs and benefits of each are roughly of the same magnitude. And, as discussed in Part V, the federal government is poised to continue this inconsistency by banning online gambling of any kind, a policy that is not only inconsistent with regulation of online trading, a similar type of speculation, but also inconsistent with existing federal policy leaving the regulation of most gambling to the individual states.

Regulation of speculation activities is overdue for harmonization. As discussed in Part III, harmonization could take the form of liberalization of gambling laws or radically tightening securities laws. Completely revamping securities laws may be not feasible at this stage in the evolution of the U.S. stock market. Various types of regulation, from tightening suitability rules to narrowing derivative choices to taxation of trading, could steer investors away from active trading programs to long-term investments.⁴⁵⁸

However, even with improvements to securities regulation, a great divide

⁴⁵⁵ *US and Antigua Dispute WTO Ruling*, BBC NEWS, Apr. 7, 2005, <http://news.bbc.co.uk/2/hi/business/4422457.stm> (quoting lawyers for Antigua as saying “[t]his is a landmark victory for Antigua”).

⁴⁵⁶ Benston, *supra* note 454 (quoting Mark Mendel, counsel for the government of Antigua, as saying that the Appellate Report “is expected to end subpoenas or threats of prosecution from the United States Justice Department to U.S. companies who choose to do business with Antigua offshore gaming companies” and that it would require the United States to allow credit card companies to provide credit to Antiguan gaming sites just as those companies provide credit to gamblers at legalized casinos in the United States).

⁴⁵⁷ See Bluestein, *supra* note 453 (citing the director of Public Citizen’s Global Trade Watch, a group critical of the WTO, as predicting that the WTO report would pave the way for other countries to complain against states that ban Internet gambling but allow lotteries or tribal gaming).

⁴⁵⁸ Stout, *supra* note 12, at 699.

will still exist between the almost laissez-faire regulation of capital markets and the tightening regulation of gambling speculation.⁴⁵⁹ Deregulating gambling will not happen instantly, because such a broad change could only be effected by the federal government. Depriving states of the ability to regulate gambling could trigger regulatory concerns. Although banning online gambling by federal fiat might survive rational basis review under the Commerce Clause as analogous to federal laws banning controlled substances,⁴⁶⁰ forbidding individual states to ban gambling may not.

At a minimum, the federal government should abandon its stance on both online gambling and sports gambling and leave to individual states the decision of whether to prohibit these activities or to regulate and tax them. If federalism promotes experimentation by the individual states, then gambling has been a perfect example of the kind of experimentation that can occur, with each state determining what is best for its populace. Securities laws even provide a model for this type of two-tier system, with states' blue-sky laws separately regulating certain investments.

CONCLUSION

At a basic level, gambling and investing are identical activities of wagering on an outcome in an environment of uncertainty. In addition, both risk-taking activities have been present in the American culture for all of its history. At some point over 100 years ago, public attitudes of the two types of speculation diverged, with investing being labeled as socially desirable and therefore supported by law, and gambling being labeled as socially undesirable and therefore prohibited by law. This divergence was based not on any logical differences in the activities, but instead on the classes of people that participated in these activities and who profited from them. Stock brokers, stock exchanges, and their wealthy clients benefited from this legal distinction; working class gamblers and bookmakers did not.

The decision to prohibit an activity should be based on a sound analysis of its costs and benefits, including whether any important freedoms are associated with that activity. Similar activities should be regulated similarly, without regard to traditional labels, pretextual and inconsistent morality arguments, or discriminatory categorizations based on class.

Although both the state and federal governments have allowed many types of gambling in the past thirty years, the recent backlash against Internet gambling demonstrates that this liberalization did not reflect a new commitment to regulating gambling similarly to other economically identical activities. Instead, gambling liberalization reflects a commitment to legalize

⁴⁵⁹ See Eggert, *supra* note 325, at 280-81 (discussing the increasing regulation of the gambling industry by the federal government).

⁴⁶⁰ See *Gonzales v. Raich*, 125 S. Ct. 2195, 2195 (2005) (holding that the Commerce Clause allows the federal government to regulate the home cultivation and use of marijuana notwithstanding California state law to the contrary).

gambling that is financially lucrative to state and federal governments. Internet gambling is not profitable to these regulators, and so it has not been legalized. Moreover, to argue that online gambling should not be permitted, regulators have renewed moralistic arguments without acknowledging that these arguments apply equally against the traditional gambling activities that they have voted to legalize.

Notably, although online investing has the same potential for negative externalities as online gambling, online investing has been accepted and even embraced as the newest manner for investing, whether rationally or irrationally, in the capital markets. Predicated upon the notion that online activities should not be regulated differently than physical activities merely because they are performed on the Internet, the SEC has chosen not to restrict online investing. Analogously, the federal government should allow states to regulate online gambling in the same way that those states choose to regulate similar physical gambling activities.