MOVING BEYOND "TAINTED ASSETS" IN CALIFORNIA

Some creative thinking is needed around the issue of PokerStars' participation or otherwise in California, argues **David Fried**, who looks at the background to the potential use of "tainted assets", and sets the ball rolling by suggesting some solutions to the current stalemate.

February saw the introduction of two identical Internet poker bills (SB 278-Hall and AB 431-Gray) in California by Senator Isadore Hall (D-Los Angeles) and Assembly Member Adam Gray (D-Merced). These are brief "spot" bills, meaning that most terms will be fleshed out as the drafts move through the committee process. However, as bills introduced by the Chairs of the two legislative committees that must address Internet poker, their introduction is a very significant development. If there is going to be successful legislation in 2015, it will be under the control of the Chairs.

With the issue of how to address "tainted assets" being one of the main policy points to be resolved, this article looks to address this more fully, while also suggesting possible solutions to the current impasse over this issue.

Defining "tainted assets"

The federal government passed the Unlawful Internet Gambling Enforcement Act (UIGEA) in late 2006. As a result, many Internet poker companies stopped taking US customers. The two largest companies who continued to take US business, PokerStars and Full Tilt, then leveraged their substantial US revenues into dominating the global market, developing advanced poker platforms and building US customer databases, the latter including hundreds of thousands of California customers. They did so in violation of law, without being licensed and paying taxes in California.

The term "tainted assets" is used in the policy debates to refer to assets derived from or used in conjunction with illegal Internet gambling activity after December 31, 2006, in violation of UIEGA and other laws (defined as "covered assets" in Nevada R. S. §463.01464).

The PokerStars and Full Tilt tainted assets were purchased last year by Amaya, which is looking to use the PokerStars brand in California. Assuming Amaya can pass suitability standards for licensing, the issue is what use can Amaya make of the tainted assets in the Golden State. However, before exploring the policy arguments in more detail, it's necessary to understand how the tainted assets can provide a significant advantage to whoever wields them.

Why the assets matter

Prior to the 2011 shutdown by federal authorities, the US Internet poker market was estimated to generate more than $1 billion in revenue on an annual basis. While other companies stopped taking US customers after UIGEA, PokerStars and Full Tilt used their US revenues to grow their share of the global market from 10.6% before UIGEA to more than 55% by 2011, with Forbes reporting that PokerStars was making $500 million a year in profits.

In 2011, the US prosecuted PokerStars, Full Tilt and other defendants for bank fraud, money laundering and gambling offenses. After many individual defendants pled guilty to their roles in the companies' acts, PokerStars settled for $731 million, acquiring Full Tilt in the process.

PokerStars' global market share is now estimated at over 60%, with the rest of the market split between approximately 500 other global operators. PokerStars' nearest competitor has approximately one-tenth its market share, with Pokerstars' continued dominance inarguably based on its having continued to take US customers after UIGEA.

As well as being the most powerful brand for Internet poker in the world today, PokerStars is also widely regarded as having the best software, the most game and tournament options, and the biggest promotions and prize pools.

PokerStars also spent hundreds of millions of dollars on marketing and promotion in the US, and is in possession of the names, addresses and email addresses of hundreds of thousands of California residents who have already played Internet poker for real money. Even if PokerStars stopped acquiring

new customer information in 2011, most people now keep their free email addresses for several years and some portion of that list would be usable. PokerStars also knows which 20% of those customers were responsible for generating more than 50% of the revenues. So while competitors can only advertise promotions to the general public through media and digital channels at a high cost per customer, PokerStars would conceivably be able to specifically target the most valuable segment of players via email at a fraction of the cost.

The brand, software and a usable customer list therefore provide PokerStars with a huge potential advantage, meaning it could easily begin with 50% or more of the California market, leaving all the other competitors to fight it out for the remaining portion. Since player liquidity is vital to building a viable online poker business, experience in other markets clearly demonstrates that operators starting with large player pools usually go on to gain more market share over time.

The case for

The PokerStars coalition, which includes two Indian Tribes and three card rooms, rhetorically couch their arguments in favour of their inclusion in terms of the "free market". They advocate for "a vibrant, competitive, fully inclusive marketplace with choices for consumers... Instead of using the legislative process to pick winners and losers, any successful legislation must allow for a variety of providers to participate in the market while relying on regulators to determine strict suitability standards." So the argument goes, their opponents must be against free markets and competition, and are trying to stack the deck in their favor by keeping the tainted assets out.

With regard to Pokerstars' past acts, at a State Assembly hearing last year, a lawyer for PokerStars' partners emphasized that PokerStars was "never convicted", with a lobbyist also stating that PokerStars "did nothing wrong."

"PokerStars could be offered the choice between using the tainted assets only in B2B commerce with scrupulously neutral business and network rules, or keeping the assets out completely."

The case against

While free market arguments can often resonate with a new audience – and most legislators are new to this issue - opponents will argue that these arguments are perverse and misleading. Gambling markets are not free markets; they are highly regulated in order to root out illegal activity and the fruits of illegal activity. Here, the key regulatory principles of fairness and providing a deterrent to illegal activity require that legislation directly preclude their use.

First, so the argument goes, precluding tainted assets is vital to fair competition and the legislation. As lawful and regulated businesses, California gambling operators have refrained from offering games over the Internet and did not develop similarly tainted assets. They had to follow the rules. Allowing tainted assets to be used against lawful operators provides an unfair and anti-competitive advantage to the PokerStars' coalition. In short, "a horse that has been fed illegal drugs should not be allowed to race, even under the colors of a new owner."

Second, permitting tainted assets to be used provides an incentive for illegal activity. People can develop assets illegally and sell them for an enormous gain if the "buyer" can be licensed and then use the assets in regulated markets. Amaya has stated that the $4.9 billion purchase of PokerStars, at 11x EBITDA and reportedly above the industry average, reflected the expectation that having new owners could pave the way for PokerStars' re-entry into lucrative US markets. Allowing the use of tainted assets therefore creates an incentive for illegal gambling operations who can cash out by selling their assets. Allowing the use of brand names associated with past illegal activity also would send the message that compliance with gambling laws is optional.

Lastly, the opponents will push back on the claim that PokerStars did nothing wrong. The US charged PokerStars and the other defendants with violating federal and state gambling laws, UIGEA, and with hiding the nature of their transactions in violation of federal laws that protect against money laundering. All but two individual defendants pled guilty to these acts. Pokerstars may have avoided a conviction by paying $731 million, but that does not exonerate anyone or remove the taint from the assets.

How can this issue be resolved?

It is unimaginable that all the interested parties will agree to either allow the tainted assets to be used without restriction, or to

exclude the assets entirely. Recently, six tribes published a letter stating that: "[T]ainted brands and assets would erode the integrity of intrastate Internet poker." Last year, 24 card rooms also signed a letter also opposing the use of tainted assets.

There have been at least two suggested compromises (detailed below), to which I have added a third.

• Leave it up to the regulator

PokerStars ideally would like the legislation to omit any reference to tainted assets. Alternatively, PokerStars would have the issue be deferred to regulators, but no doubt PokerStars will want to define the subject assets or the scope of regulatory authority as narrowly as possible. That is unlikely to fly with the opponents. There also are cogent policy reasons as to why the issue should be addressed in the actual legislation. California businesses that want to offer Internet poker will not spend tens of millions of dollars each before launch on capital investment in our state - hiring employees, entering into contracts for services and technology and creating new infrastructure - if market competition is a pretense from the outset. If there is uncertainty over the use of tainted assets, then many potential applicants will stay out of the market as happened elsewhere. This will cost California hundreds of millions of dollars in economic investment and tens of millions of dollars of advance tax payments. Instead of a robust market with 6-8 competitors, we will have far fewer license applicants and less money for the state.

• The penalty box option

Another possibility is to put the tainted assets in a penalty box and restrict their use for a fixed period of time. But there is some evidence that a penalty box, at least a short one, has little effect. In Italy, PokerStars was authorized to operate the year following the opening of the market for real-money tournaments. Pokerstars had its brand and a recent customer list from Italy built from operating in the market before it was granted an Italian license. Competing against other companies that launched the prior year, Pokerstars initially had 8.7% of the market. But that has steadily changed, and today Pokerstars has more than 60% of the regulated market. So, a penalty period is unlikely to change anything unless the period is substantial.

• Neutralize the assets' competitive advantage

At least another possibility – conceptual and not yet endorsed by a single interest group – could be to permit the tainted assets to be used only in B2B commerce and with scrupulously neutral business and network rules. PokerStars could be offered the choice between using the tainted assets with these conditions or keeping the assets out completely.

For example, one condition on the use of the tainted assets could be that PokerStars opens their software and network to any licensed operator on equal terms, rather than restricting their use to a few parties. This means the software will be open to use by all licensed operators, without PokerStars favoring a select few companies.

A customer would receive marketing from and register with a licensed operator. The customers of all the operators that opt to use PokerStars' network would be pooled on virtual poker tables clearly labeled as "Powered by PokerStars." This would permit the use of PokerStars' brand and software without giving favoritism or a preference to any operator. PokerStars could charge every operator opting in a percentage of gross revenues off the top for the use of the assets, with each licensed operator responsible for their own administration, operations, marketing, customer accounts, budgets and financing.

PokerStars' current California partners are highly likely to oppose this, since they clearly want to use tainted assets to squash competition from all the other operators. I am not sure that Amaya and PokerStars would be too supportive of the idea either, but the company will at least have had the advantage of having its name and software in use in the largest single market in the US, and without having to capitalize the market entry and working capital for a few restricted partners.

While these are just some early thoughts as to how to resolve this issue, and are likely to be dismissed as such from certain quarters, it's clear that some creative thinking is urgently required here, as boiling it down to a stark choice between letting the tainted assets in or keeping them out means we are unlikely to overcome the stalemate we are currently facing.

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