Here Come the Cybercops 3: Betting on the Net

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As the Internet plays an increasing role in American culture, more and more people are betting on the Net—everything from sports betting to casino gambling, from playing the stock market, the world’s largest crap game, to falling for various get-rich-quick schemes. In this era of irrational exuberance, who can resist? Who is betting on the Net? Who stands to profit from it? Who wants to regulate it?

A wealth of federal and state law exists to regulate securities transactions, but recently Congress has acted to limit the rights of states to regulate securities transactions. Regulation of gambling has been the exclusive province of the states, but some members of Congress would also like that to change. In 1996, Congress commissioned a two-year multi-million dollar study of the national impact of gambling, “whether conducted in a casino, on a riverboat, on the Internet, on an Indian reservation, or anywhere else in the United States.” The Commission’s report is expected to be released later this year. Without waiting for the Commission’s findings, members of Congress have already introduced legislation to prohibit gambling on the Internet.

A. Cybercommerce and Cybercops

The exponential growth of the Internet has prompted governments around the world to look at ways they might regulate and derive revenue from cybercommerce. Worldwide, there are approximately ten million host computers with forty million users. It is projected there will be 200 million users by 1999. Seventy percent of companies in the United States have web sites to promote their products and ten percent sell their products online. That number is expected to increase to forty percent within the next two

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3. Id.
It has been estimated that new websites are appearing at the rate of 65,000 per hour. The United States is home to the greatest number of host computers; about half of the total host computers are in the United States, followed by Germany, the United Kingdom, Canada, and Australia, with Japan, Finland, the Netherlands, Sweden, and France finishing in the top ten. It is estimated that the annual worldwide revenue on the Internet will reach nearly eighty billion dollars by the year 2000. It is no surprise that legislatures around the world are considering regulating the Internet.

In the United States, numerous federal and state agencies are monitoring the Net to crack down on online fraud in connection with so-called business opportunities and investments. The Federal Trade Commission's cyberspace sheriff receives between 100 and 200 complaints a month. The Security Exchange Commission's ("SEC") cyberforce, composed of sixty attorneys and accountants, receives between thirty and forty complaints per day from private cybersleuths. So far, the cyberforce has prosecuted about a dozen complaints, including one against a teenager in Ohio who had a web page with the "SEC's Top Ten Stockpicks." Postings on legitimate bulletin boards on the Internet are no different than those found in newspapers, heard on the radio, or promoted on television; these include "make money at home," "own your own business," and "buy real estate for nothing down." Bulletin boards have also become a new source for "pump and dump" operators—the old boiler room approach of creating demand for a penny stock and then dumping when the created demand pumps up the price.

Even though these slogans are typical fraud, consumers seem more likely to fall for it on the Net. Perhaps it is a generation growing up in front

5. Id.
8. Id.
9. Id.
10. Information on the various federal and state agencies and private entities patrolling the Net is provided in "The Information Highway Patrol: Here Come the Cybercops," paper presented at the Twenty-Sixth Popular Culture Association and Eighteenth American Culture Association Annual Conference, Las Vegas, Nev. (Mar. 24-28, 1996).
13. Id.
Koegler: Here Come the Cybercops 3: Betting on the Net

of a television screen who believe all, not half, of what they see, even if they believe none of what they hear. Perhaps it is a generation growing up with calculators who believe what they see, even if the decimal point is in the wrong place. Perhaps it is because one must take some positive action to reach these web sites, and hence one's guard is not raised as it might be when approached by a stranger in person or by telephone. But, we are more gullible on line. For example, in the case of online pen pals, based on their "friendship," one sent the other a check for ten thousand dollars to invest in a nonexistent mutual fund.15

B. Security Online: Encryption

Security of transactions on the Net without public release of private information generally involves some sort of encryption technique by which the communications are scrambled and descrambled. For example, the various Internet casinos and lotteries utilize secure transmissions; the host computer and user computer use an encryption scheme to scramble the communications.16 International transactions, and to a lesser extent, interstate transactions on the Net have been handicapped by the United States' restrictions on encryption software.17 The Arms Export Control Act ("AECA") authorizes the President to control the import and export of defense items by designating them to the United States Munitions List ("USML").18 Encryption software has long been on the USML list.19 Thus, such software has to be submitted to the State Department in order to obtain a license for export.20

A mathematics Ph.D. candidate, who submitted a computer source code and an explanatory academic paper and who was denied a license under the AECA, brought suit challenging the constitutionality of the statute and the associated regulations in Bernstein v. United States Department of State ("Bernstein I").21 After the suit in Bernstein I was filed, the State Department reevaluated its classification of the academic paper; as recognized by the court: "The paper, an academic writing explaining plaintiff's scientific work in the field of cryptography, is speech of the most

18. 22 U.S.C. § 2778(a)(1) (1994). This designation is not subject to judicial review. Id. § 2778(h).
The court relied on copyright law in determining that "source code is speech" for purposes of the First Amendment.

In Bernstein v. United States Department of State ("Bernstein II"), the court determined that the licensing scheme constituted a prior restraint on speech and that the regulations provided no limits on discretion in licensing. The regulation failed to neither provide a certain time limit for making a decision nor for judicial review; the burden was placed on the licensor to support the denial. Thus, the court concluded that the licensing system constituted an unconstitutional prior restraint in violation of the First Amendment.

Just before the decision was entered in Bernstein II, the President signed an executive order transferring from the State Department to the Commerce Department the authority to license the import and export of nonmilitary encryption software as an exercise of his temporary national emergency power. The order provided that "the export of encryption software, like the export of other encryption products described in this section, must be controlled because of such software's functional capacity, rather than because of any possible informational value of such software." Despite the President's express language, in Bernstein III, the court adhered to its opinion that the encryption source code was speech and determined, notwithstanding some differences in the new regulations before the court, that the regulations still constituted an unconstitutional prior restraint for substantially the same reasons as stated in Bernstein II.

During pendency of the Bernstein cases in 1996, forty-bit encryption software was used by access providers on the Net, despite customers' complaints that the forty-bit code had been cracked by hackers. United States citizens could order 128-bit encryption code by mail, but could only download forty-bit code from the Net because export of encryption code was limited to forty-bit code. In mid-1996, the government approved distribution of 128-bit encryption code over the Net to United States citizens.
through Netscape; however, each request for distribution was subject to screening by Netscape because the State Department "fears foreign terrorists or criminals could use the software to threaten national security." In late 1996, the President signed an executive order to permit the export of the 128-bit code and computers containing such code, subject to providing United States law enforcement with "keys" to intercept and decode communications and subject to "licensing" of the seller. Time will tell whether this new order will facilitate secure transactions on the Net.

C. Securities Online: One Way to Bet on the Net

For several years, brokerage companies have been offering online investing. Television commercials depict the addictive nature of online investing. More recently, television, radio, and newspaper advertisements solicit people to train as online or day traders, to be their own boss, and not to worry about job security. The number of brokerage companies offering online trading has doubled from thirty-three in 1996 to sixty by the end of 1997, with some fourteen million accounts predicted to be online by the end of 2002.

More recently, brokerage and research companies have begun offering a wide variety of financial information online. The SEC now requires electronic filing of some documents, including registration statements and prospectuses. Electronic filing of other documents, including annual reports, is optional. Filings relating to exempt securities are still "paper only." All electronic filings since January of 1994 are contained in the SEC's Electronic Data Gathering, Analysis and Retrieval System ("EDGAR") database. EDGAR was initially available online through "Disclosure," a program on Lexis/Nexis, at a hefty cost, and hence was used primarily by businesses. Temporary government funding made EDGAR freely available over the Net, thus extending its availability to individuals

32. Id.
37. Id. § 232.101(b).
38. Id. § 232.101(c).
through joint management by New York University and Internet Multicasting Service. It proved so popular that the SEC arranged to keep the program operating, prompting Disclosure to offer free Internet access to EDGAR as well.

The SEC also permits electronic delivery of mandated disclosure documents to shareholders. The documents must be posted on the company’s web page, available until the annual meeting, and in accordance with the following rules: a paper copy must be available on request; they must have some way of confirming receipt by shareholders; and the shareholder must have given informed consent. A shareholder who wishes to receive annual reports and proxy statements via e-mail can contact the appropriate web site and follow the instructions. Shareholders may also be able to vote their proxies by e-mail.

The birth of direct stock offering over the Net can be traced to Spring Street Brewing Company. Spring Street first made the news when it went public in March of 1995, without an underwriter, by advertising its shares on the Net. Its founder, Andrew Klein, was a securities lawyer. The stock was registered for sale in fifteen states. Since it was not listed on an exchange and limited in size, it did not need to meet the stiffest requirement of the SEC. Nor were there any investment bankers, brokers, or research analysts reviewing, or touting, the offering. Nor, for that matter, was there any market for the shares.

Spring Street made news a year later in March of 1996, when it offered its stock directly to purchasers over the Internet. After making two sales, it voluntarily suspended trading pending a review by the SEC. The SEC objected to the fact that Spring Street directly took the money in exchange for the shares, since Spring Street was not a registered broker/dealer;

40. See Allison, supra note 39, at 93 n. 25.
41. See Siwolop, supra note 35, at 1.
42. See Hewitt, supra note 12.
43. Id.
44. E.g., Gateway 2000 notice, Jan. 27, 1998, directing shareholders to investordelivery.com. Caveat actor: electing this option for one company can result in electronic delivery of information for other companies held in the same brokerage account. Id.
45. IBM press announcement (CNBC television broadcast, March 18, 1998).
47. Id.
therefore, Spring Street arranged for the money to go to an escrow agent. The SEC allowed the Internet sales and a new industry was born. Its founder, Andrew Klein, has since gone on to found Wit Securities which provides Internet stock offerings for other start-up companies. To date, the company has done seven public offerings. According to Mr. Klein, in the most recent offering, e-mail notification was sent to a million potential purchasers, nineteen thousand of whom clicked on to the web site to get the prospectus for the offering.

Other direct stock offerings on the Internet include Destiny Pictures, which made a public offering online in the spring of 1997, seeking to raise half the equity in a new picture *Intimate Stranger*, which was considered an "erotic thriller." Caveat emptor: The offering was not registered with any state securities authority. Caveat venditor: States are taking the position that if it is downloaded in the state, it is an offering in the state.

However, states have considerably less authority to regulate securities offerings than in the past. Although federal and state securities law had existed side-by-side since the early 1930s, the Capital Markets Efficiency Act of 1996 preempted certain state legislation. Federal registration for nationally traded securities (those traded on the New York Stock Exchange ("NYSE"), American Stock Exchange ("AMEX"), or the National Association of Securities Dealers Automated Quotations ("NASDAQ") is now exclusive; these securities are now exempt from state requirements. Rules on broker/dealers were also limited to the federal rules, and a national de minimis exception for dealing across state lines was enacted. The only area not preempted, aside from local securities exempt from national registration, was the state’s right to investigate and prosecute fraud and deceit in the sale of securities.

D. Gambling Online: A New Way to Bet on the Net

Licensed gaming has long been recognized as a matter reserved to the states within the meaning of the Tenth Amendment. Forty-eight states

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51. Id.
55. Id. § 78o.
56. Id. § 77r.
(every state except Hawaii and Utah) allow some form of gambling.\textsuperscript{58} Thirteen states have casino gambling; only one, Nevada, has sports gambling.\textsuperscript{59} Thirty-six states and the District of Columbia have state lotteries.\textsuperscript{60} These figures neither include gambling on Native American lands nor cruises to nowhere but international waters for the purpose of gambling. The annual revenue casinos take in alone exceeds the combined amount of money spent annually on movies, theater, and concerts.\textsuperscript{61} It is estimated that online betting will generate more than ten billion dollars per year by the year 2000.\textsuperscript{62}

Although regulation of gaming on Native American tribal lands falls to Congress under the Indian Commerce Clause of the Constitution,\textsuperscript{63} Congress has ceded some authority to the states. In 1988, Congress enacted the Indian Gaming Regulation Act ("IGRA").\textsuperscript{64} The purposes of the Act include:

\begin{quote}
[T]o provide a statutory basis for the regulation of gaming by an Indian tribe adequate to shield it from organized crime and other corrupting influences, to ensure that the Indian tribe is the primary beneficiary of the gaming operation, and to assure that gaming is conducted fairly and honestly by both the operator and the players.\textsuperscript{65}
\end{quote}

In other words, Congress decided that the Native American tribes are not capable of running their own business. Congress also determined that "Indian tribes have the exclusive right to regulate gaming activity on Indian lands if the gaming activity is not specifically prohibited by federal law and is conducted within a state which does not, as a matter of criminal law and public policy, prohibit such gaming activity."\textsuperscript{66} In essence, Native American tribes do not

\begin{itemize}
\item powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X.
\item 59. See McCollum, supra note 58.
\item 61. James Sterngold, Imagine the Internet as Electronic Casino, N.Y. TIMES, Oct. 22, 1995, at 3.
\item 63. The Constitution provides in pertinent part: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. CONST., art. I, § 8, cl. 3.
\item 66. Id. § 2701(5).
\end{itemize}
have the exclusive right to regulate their own gaming activity. Rather, Congress limited such exclusivity to bingo and similar games; as to casino gambling, slot machines, dog racing, lotteries, and the like, the tribes were required to negotiate a compact with the state in which they were located.\footnote{67. Id. § 2710; § 2703(7)(A).}

Under the IGRA, a state was required to negotiate in good faith and a failure could subject the state to suit, only if the state agreed to be sued.\footnote{68. Seminole Tribe of Fla. v. Florida, 517 U.S. 44, 47 (1996) (citing 25 U.S.C. § 2710(d) (1994)).} Even though the granting to the states of some measure of authority over gaming on Native American lands “extends to the States a power withheld from them by the Constitution,”\footnote{69. Id. at 58.} “the Eleventh Amendment prevents congressional authorization of suits by private parties against unconsenting States.”\footnote{70. Id. at 72.} Hence, the right of a tribe to sue to compel good faith negotiation depends on the state’s consent to be sued. So, if a state has a lottery and does not want competition on Native American lands, it can refuse to negotiate the necessary compact and it can refuse to be sued. Nevertheless, many states feel they do not have sufficient control over Native American gaming within their jurisdiction or without.\footnote{71. H.R. REP. NO. 104-440 at 5, 1996 U.S.C.C.A.N. at 1194.}

In June of 1997, the Coeur d’Alene’s Indian tribe in Idaho opened what is believed to be the first Internet gambling site based in the United States, which reportedly has been denounced by the Governor of Idaho.\footnote{72. Tribe Starts New Business: Gambling Site on Internet, N.Y. TIMES, July 5, 1997, at 6.} The tribe first opened bingo and casino gambling in 1993; the web site provides scratch tickets, blackjack, and lotto games.\footnote{73. Id.} Already, the Attorney General of Missouri has brought suit against the Internet carriers seeking blocking of the games; other attorney generals may rally to the call.\footnote{74. Id.}

Private entities are also gearing up to offer Internet gambling. “Think about it. You’re at your desk or in your home and all of a sudden you have an urge to gamble. Just click an icon on your computer and next thing you know you’re at our casino,” said the Chief Executive Officer of Internet Casinos.\footnote{75. Copilevitz, supra note 16, at 1A.} Internet Casinos has no physical casino, only computers, based in St. Marten, with additional operations in a half dozen other countries.\footnote{76. Id.} Although Internet Casinos do not accept memberships from United States
residents, some users in the United States have reportedly been able to get online. 77

Sports International, Ltd., based in Antigua and limited to sports betting, has started accepting Internet wagers after years of accepting telephone wagers. 78 Customers who find the web site can complete an application, wire the money to Antigua, and start betting within a half-hour. 79 VentureTech Inc. in Reston, Virginia planned to be online in 1997, but only outside the United States, pending resolution of the legal issues. 80

World Wide Web Casinos bases its betting in real casinos in Antigua and in computer-based operations in South Africa. 81 Potential customers can fill out an online registration and set up an account by credit card online or by mailing a check. 82 Customers can either receive a packet of CD-ROMs with the necessary software by mail or directly download the necessary software, and a Visa debit card reflects wins and losses. 83

Betting on the Net is not confined to private offerings. New York State's Off-track Betting (“OTB”) is getting into the act. In late 1996, the state announced that in addition to setting up accounts online, customers soon would be able to place their bets online. 84 Another example is the country of Liechtenstein, which runs a lottery over the Internet—six numbers cost six dollars for a chance to win one million dollars. 85 Liechtenstein considers people coming to their web site as coming to Liechtenstein and thus subject only to Liechtenstein’s laws. 86

E. Regulating Betting on the Net

Over opposition that regulation of gaming is reserved to the states under the Tenth Amendment, Congress has already commissioned a study of gambling. 87 Proponents of the Commission, the House Judiciary Committee, argue that “insofar as the bill relates to Indian gambling, it falls within the

77. Id.
78. Id.
79. Id.
80. See Miller, supra note 62, at D1.
81. See Copilevitz, supra note 16, at 1A.
82. Id.
83. See Miller, supra note 62, at D1.
85. See Copilevitz, supra note 16, at 1A.
86. Id.
power of Congress to regulate commerce with the Indian tribes."  

Proponents also argue that it falls within the commerce clause: "For example, many gamblers cross state lines to travel to gambling operations. That alone is enough to bring gambling within the interstate commerce clause." A lot of theater-goers cross state lines to travel to Broadway. That alone is not enough to bring Broadway shows within the interstate commerce clause.

And then they argue that: "Gambling, and the public corruption that has come with it in some instances, implicate a variety of federal criminal statutes . . . . The Committee is not aware of any instance in which any of these statutes has been held to exceed the power of Congress to regulate interstate commerce." This may be true, but the Commission is intended to study the effects of legal gambling not illegal gambling.

Additionally, proponents of the Commission argue that "Congress can look into any matter [at] least for the limited purpose of determining whether it is properly within its legislative powers." For this, Congress needs two years and millions of dollars? They argue that the legislation only empowers the Commission to conduct a study and that "[f]ederal regulation of gambling is not in issue at this time." After two years and millions of dollars, how likely is it that the Commission will not determine that regulation is necessary?

In the meantime, the people both inside and outside the Washington beltway, are not waiting for the Commission's study. In fact two separate bills are currently being considered by Congress. In addition, bills to regulate Internet gambling are under consideration in at least eight states.

88. Id. at 1196.
89. Id.
90. Id. at 1196–97.
91. Interestingly, the legislation was codified as a note to 18 U.S.C. § 1955 (1994) in the Chapter 95 on "Racketeering," rather than in the Chapter 50 on "Gambling."
93. Id. at 1196.
94. These include the 1997 House Bill No. 2380 (Goodlatte), which was sent to the Judiciary Committee on Sept. 3, 1997, and 1997 Senate Bill No. 474 (Kyle), which was sent to the Judiciary Committee on March 19, 1997, and reported out of committee on October 23, 1997, as amended.
F. Conclusion

There is no need for the pending federal legislation. If offshore gaming exists, money is going to flow overseas. Similarly, collecting taxes on winnings will be more difficult, if not impossible, as long as the host site is off-shore. Prohibiting Internet gambling is likely to do more harm than good.

The Department of Justice already has the authority to prosecute illegal interstate gambling, including betting on the Net. Title 18 prohibits the use of

> a wire communication facility for the transmission in interstate or foreign commerce of bets or wagers or information assisting in the placing of bets or wagers on any sporting event or contest, or for the transmission of a wire communication which entitles the recipient to receive money or credit as a result of bets or wagers.

The Department of Justice, of course, has no jurisdiction overseas: "If the casinos are outside the United States, there's not a thing we can do about it . . . ," and it is unlikely to prosecute individuals who gamble over the Net.

Those who want the federal government to prohibit Internet gambling have raised a host of reasons that do not stand up to investigation. Regarding the concern that individuals need protection from fraud or pyramid schemes, such protection could be enforced more readily against sites based in the United States or, at least, controlled by United States companies. For example, the FTC shut down an Internet-based pyramid scam run by a company in Washington; the injunction ordered the company to return to the United States approximately three-and-a-half million dollars that had been transferred to an account in Antigua. In addition, the Minnesota Attorney General is prosecuting a Nevada company for illegal

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96. See McCollum, supra note 58; Copilevitz, supra note 16.
97. 18 U.S.C. § 1084(a) (1994): "[A] wire communication facility" includes "any and all instrumentalities, personnel, and services . . . used or useful in the transmission of writings, signs, pictures, and sounds of all kinds by aid of wire, cable, or other like connection." Id.
98. See Copilevitz, supra note 16, at 1A (quoting John Russell, spokesman for the Department of Justice); see McCollum, supra note 58.
bookmaking, even though the company sought to avoid United States laws by setting up its WagerNet bookmaking service in Belize.\textsuperscript{101}

One commonly cited issue is the restriction of access to prevent children from betting online.\textsuperscript{102} One needs to take active steps to create, fund, and access a gambling account, just as one needs to take such steps with regard to an investment account. In the years since companies have permitted trading online, the media have been devoid of any stories of children trading in their parents' accounts. There is no reason to believe that casinos will not be equally protective of their accounts. Moreover, the necessary steps to prevent access to gambling by minors have already been vetted in the development of the regulations relating to preventing access to obscenity by minors.\textsuperscript{103}

Another issue commonly raised is compulsive gamblers: "'The person never has to get up from their chair and[,] in no time at all, can lose a lot of money.'"\textsuperscript{104} It has been argued that at-home electronic wagering removes too many necessary controls, such as urging gamblers to take a break.\textsuperscript{105} Losses will, of course, be limited to what customers have in their accounts. Do we need to tell high rollers how to spend their money? We do not tell investors how much or how to spend money online. More problematic is the issue raised by New York's OTB going online; can state lotteries be far behind? Lottery players are not high rollers. Yet, it is unlikely the federal government could, or should, interfere with state lotteries.

The states should retain the right to regulate gambling within their own jurisdiction. Thus, if New York wishes to permit online betting, it can; if Missouri wishes to prohibit it, it can.

[T]he thrust of the legislation clearly reflects a view that the states have chosen unwisely by allowing their private citizens to spend too much of their own funds on gambling. The notion that the federal government should rebuke the states for allowing private citizens to gamble with their own money in privately run gambling

\textsuperscript{101} See Humprey v. Granite Gate Resorts, Inc., 568 N.W.2d 715 (Minn. 1997); Julio Ojeda-Zapata, \textit{Computerized Sleuthing Becomes Virtual Reality}, STAR-LEDGER (Newark, N.J.), Dec. 17, 1995, at 52. It is thought to be the first criminal case with jurisdiction based on the ability of state residents to access the site through the Internet. \textit{Id.}

\textsuperscript{102} See Copilevitz, \textit{supra} note 16 (citing Sue Cox, Director of the Texas Council on Problem and Compulsive Gambling); McCollum, \textit{supra} note 58; Horn, \textit{supra} note 99.

\textsuperscript{103} See generally Reno v. ACLU, 117 S. Ct. 2339 (1997); see also discussion in \textit{The Information Highway Patrol: Here Come the Cybercops}, \textit{supra} note 10.

\textsuperscript{104} See OTB Web Site to Let Bettors Play the Ponies On-Line, \textit{supra} note 84 (quoting Laura Letson, director of the New York Council on Problem Gambling).

\textsuperscript{105} See Copilevitz, \textit{supra} note 16, at 1A (citing Sue Cox, Director of the Texas Council on Problem and Compulsive Gambling).
enterprises seems to me to be the antithesis of a respect both for the rights of states and for individual choices about how they should spend their own money.106

Do we need federal regulation of Internet gambling? No.