

Testimony of Jack A. Blum, Esq.

Before the Senate Committee on Commerce, Science, and Transportation

Consumer Protection Subcommittee

On

Internet Gambling, Money Laundering and Tax evasion

July 17, 2013

My name is Jack A. Blum. I am a Washington, D.C. lawyer specializing in money laundering compliance, offshore tax evasion and financial crime. I am appearing here this morning at the request of the Committee. I do not have clients with an interest in internet gambling. Personally, I think gambling is dumb and I learned early on that the house always wins.

Gambling and organized crime have had a long standing relationship. When the Justice Department nailed Al Capone it was for tax evasion. The financial wizard of organized crime, Meyer Lansky, understood that criminal proceeds had to be legitimized. He taught the criminal world that the best way to do it was to own either a race track or a gambling casino. Lansky gained control of Cuba's race tracks before the outbreak of World War II. The East Coast's organized crime families deposited their profits from prostitution, illegal gambling, and drugs in the Cuban race track's bank accounts in Florida as the track's take on the pari-mutuel betting in Cuba. Magically, criminal proceeds from the US East Coast became legitimate race track profits from Havana.

In the early 1990's I was hired to investigate money laundering on the Caribbean island of St. Maarten. An Italian with organized crime connections had taken over the island casino business. Each day the casinos deposited large amounts of cash as the "house take." In fact when I visited the casinos there were very few customers and hardly enough activity to bother keeping the doors open. I found the explanation at the St. Maarten airport where each day flights would arrive from San Juan and Miami and would be met by armored cars. Mailbags of cash were offloaded and taken to the banks to be deposited as gambling winnings. The Dutch Ministry of Justice and the DEA broke the mafia hold on the island and the laundering stopped -- at least for a while.

The moral of these stories is simple – casino ownership and operation must be regulated. Casino books need to be audited and the gaming should be supervised to prevent buying and selling chips from becoming another way of laundering cash and to prevent the casino being used to cover large criminal money movements. The states that got into the business early, Nevada and New Jersey learned their regulatory lessons the hard way and established respected regulatory organizations. Other states followed suit and as long as gambling was tied to bricks and mortar the problems were manageable.

Unfortunately, the development of the internet and global electronic commerce has made serious control of gambling very difficult. In the new world of electronic commerce the definition of a financial institution has become any business enterprise that has an encrypted switch – that is to say it has

customer accounts from which funds come and go and which are protected through some form of encryption. Functionally an online casino is no different than a bank even though its purpose is different. It has customer accounts that have balances. Customers can add or withdraw money at will, and if the operator is willing, balances can be transferred from one account to another. It stands to reason that a casino should have the same anti-money laundering controls that banks have. Casinos should be required to know their customers, they should be required to monitor accounts for suspicious transactions, and casinos should be audited for the protection of customers and to insure compliance with the anti-money laundering regime.

Online casinos can operate from any jurisdiction. Offshore casinos have developed sophisticated methods of avoiding supervision and US law. I suspect more than a few of the existing offshore casinos have money laundering and illicit funds transfer as their principal purpose.

To make matters worse we now must confront the use of artificial currency such as the Bitcoin that is beyond the reach of governments.

As part of a consulting assignment for a federal agency I began to look into what is called the offshore merchant business. The idea behind becoming an offshore merchant was that a business based on the internet could direct all customer payments for services in the US to an offshore account that would accept credit cards. The funds would be untraceable and the offshore merchant would thus avoid showing income in the US and evade federal and state tax.

To make the offshore operation opaque service providers in offshore jurisdictions offered “cells” in what are called protected cell companies. These companies have an overarching company with bank accounts and a visible identity, but they are made up of individual cells, each with a different owner, and each financially independent of the other. There is no way for foreign law enforcement to find the ownership of the individual cell companies. Even the local governments do not know the owners of the cells.

Protected cells are just one of a number of ways of hiding financial operations offshore. Untraceable shell companies, trusts and other devices are in widespread use. Indeed, Senator Levin has introduced legislation aimed at putting an end to anonymous corporations here in the US – legislation that I strongly support.

In doing my research, I found several service providers who offered casino gambling site software with a full complement of games and the ability to set up individual customer accounts. By the way – many of these same service providers also offered pornographic sites protected by a pay firewall. The software is designed to be controlled by an individual cell company far out of reach of regulation, taxation, and prosecution for fraud.

Congressional efforts at controlling offshore online gambling activities have met with limited success. The principal piece of legislation in this area is the 2006 Unlawful Internet Gambling Enforcement Act. That Act bars the use of checks and credit cards in payment for illegal gambling activities. The word is “illegal.” The definition of illegal was based on the Wire Act of 1961 that banned the use of interstate wire communications for both sports and no-sports gambling. The ban on the use of payment systems

put the banks in the business of policing customers to make sure the only online firms that used bank accounts and credit cards were offering “legal” gambling services – that is to say gambling allowed by state law.

The one prosecution and conviction of note under the UIGEA targeted the operators of a sports book based in Antigua that accepted bets from US persons. The operators of the sports book, Daniel Eremian and Todd Lyons, operated openly and flamboyantly, almost daring the Department of Justice to prosecute. Most likely at their instigation the government of Antigua filed a complaint against the United States under the WTO rules. Antigua claimed that the US law aimed at their offshore casinos was an act of trade discrimination.

As the prosecution of Sports Offshore was taking place, the Department of Justice changed its interpretation of the Wire Act. It said that the Act only applied to sports betting. The Justice opinion ended the effectiveness of the ban on bank transfers and credit cards for casinos that limited themselves to electronic table games and slots and left the field wide open for gambling web sites. After the DOJ opinion, web sites that offered casino games that were now considered legal could use bank payment systems.

To the extent that the controls on payments for online gambling worked, they kept American customers away from the offshore sites. The Justice Department decision to give up on the control of interstate gambling other than sports gambling has opened the door wide to any entrepreneur legitimate or otherwise who wants to get in the business. It tore up the Wire Act - an act that was the result of extensive hearings on organized crime and gambling by Senator Estes Kefauver and the Senate Permanent Investigations Subcommittee. It left behind a maze of state laws and no real way of regulating the internet gambling business.

The current situation raises the question of whether there will be any controls on the business of internet gambling or whether we will go back to the days of Al Capone and Meyer Lansky. To prevent money laundering through an internet site the sites will have to be licensed, audited, and regulated. The applicants for a license will have to be screened for fitness and to ensure they do not have criminal pasts or criminal connections. The operations will have to be audited to insure that the stated earnings in fact come from ‘house’ winnings. Customers will have to be subjected to due diligence under ‘know your customer’ rules. Casino operators will have to file suspicious activity reports on customer accounts with the Treasury’s FINCEN. They will have to be audited to insure the suspicious activity reports are in fact filed and that the operators are screening customers and the activity in customer accounts.

There will also have to be systems to insure that winnings are reported to IRS and taxes are paid.

Finally, the auditors will have to insure that the online casinos do not become sophisticated money transfer systems – a kind of online Hawala exchange. An unscrupulous operator could take funds from a US gambler, and pay ‘winnings’ to a foreign player’s account. Or the money could move from an offshore player to an onshore player. The possibilities for terrorist financing and for moving the proceeds of white collar crime using this system are endless.

What part of government will take on the regulatory responsibility? What part of the government is equipped to supervise a sophisticated and very large financial industry? Most certainly it cannot be the IRS -- an agency that has had its budget cut three times in the past three years and has been given the added responsibility of implementing the new healthcare legislation. You will have to create a new specialized regulatory agency, perhaps as a part of the Treasury Department that will take on the job.

The regulatory problem cannot be solved by a software system alone no matter how sophisticated the system is. Screening systems all require human intervention to screen the computer search results and to integrate the results in ways that lead to enforcement action. Moreover we have all seen what happens when a financial institution, which a casino is, gives up on its regulatory responsibility. The example I have in mind is HSBC which laundered four trillion dollars in drug money, computer screening systems notwithstanding.

I believe that the new regulatory agency Congress will have to create will have to be staffed by experts with the resources to do the hard work of keeping the industry honest. I do not think this kind of regulation can be done at the state level. The regulation will be expensive and the industry will have to be taxed to pay for regulation.

I do not believe prohibiting internet gambling will work. The horse has left the barn. The internet is too open to control and in any event controls will not work across state and national borders. What we have to hope is that a new federal agency can inspire enough trust to encourage customers to use US sites, and that competitors will report problem sites to the regulators and the law enforcement authorities. The regulators will also have to screen the internet regularly for pop-up casino sites that are attempting to avoid controls. There will have to be limits placed on bank transfers to offshore casinos.

You will have to address the issue of online gambling one way or another. The sooner the problem is addressed the better because the present situation is out of control. A simple internet search for online casinos will show you how many players have entered the field. Crafting appropriate legislation will take a concerted effort by Congress with the help of the agencies now tasked with money laundering prevention.

I hope you have found this testimony helpful and I will be happy to answer any questions you may have.