

Appendix 8 Internet Gaming and South Africa: Implications, Costs
& Opportunities

INTERIM REPORT

FOR

THE NATIONAL GAMBLING BOARD

PROJECT SOUTH AFRICA

**INTERNET GAMING AND SOUTH AFRICA:
IMPLICATIONS, COSTS & OPPORTUNITIES**

**Prepared by the National Centre
for Academic Research into Gaming**

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PROJECT SOUTH AFRICA

Internet Gaming and South Africa: Implications, Costs & Opportunities

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I INTRODUCTION

An Export Opportunity

From the point of view of protecting and promoting the public interest, the policy issues surrounding Internet gaming are quite different from those which are relevant in relation to the legalisation and regulation of land-based gaming. The reason for this is that the potential market for Internet gaming is overwhelmingly made up of people living in other countries: almost certainly more than 98% of those who will patronise South African-based Internet gaming sites will be international consumers. In fact, South Africa accounts for only one million of the 140-million international Internet users.

This means that Internet gaming is a dollar-earning *export* business. Almost all sound strategy relating to its regulation follows from this fact.

Some people used to think that casinos in South Africa would prove a significant drawcard to foreign tourists and would consequently constitute a valuable export business and source of foreign earnings. Such thinking was always misguided in respect of land-based gambling which, in South Africa, will overwhelmingly cater for domestic players. However, the opportunities for earning foreign currency which Internet gaming offers are potentially vast. Estimates of a 25%-33% share of a \$7-billion industry for South African-based Internet gaming businesses within two years are not unreasonable, given the right policies. It is also not unreasonable to expect these earnings to be sustainable, provided businesses operating out of South Africa establish themselves before those of other credible and competing countries. After 2001, for reasons set out below, the global market for Internet gaming is almost certain to grow hugely.

E-Commerce

However, there may be an even more important benefit for South Africa to be derived from the rapid introduction of a sound regulatory environment for Internet gaming. This is that it would act as a spearhead for the development of South Africa as a thriving centre for e-commerce businesses generally.

South Africa needs to compete globally and is no longer able to rely on mining – and other traditional sectors - as a sufficient means for doing this. Its physical distance from global markets place it at a disadvantage in relation to other activities in which it might expect to compete successfully over a sustained period. On the other hand to develop as a successful centre for e-commerce only two ingredients are essential:

- Availability of good quality IT infrastructure; and
- A first-rate regulatory environment which is attractive to both the providers and consumers of Internet services.

South Africa is in a good position to develop both in a short period and, consequently, to attract the suppliers of diverse services through the Internet to locate their companies in South Africa.

On the other hand, the potential of the Internet gaming market is already being understood and, to some extent, exploited in other countries. In considering the legalisation and regulation of Internet gaming, therefore, the South African government needs to think of itself as acting on behalf of “South Africa Incorporated” in an enterprise which will be internationally-competitive and successful.

South African policy in this regard must seek to make South Africa the jurisdiction in which Internet gaming providers operate and pay taxes in preference to Antigua, Australia, Europe, the Channel Islands and other jurisdictions of the twenty-five countries who have legalised Internet gaming. Fortunately current circumstances are remarkably favourable for such a national enterprise.

II BACKGROUND

By the late 1990s, in South Africa, the US, Canada, the European community, Asia and Australasia, there has emerged a substantial increase in the legal and social acceptance of gambling and commercial gaming. In the United States alone, the industry grew from \$10-billion in 1982 to \$50-billion in 1997^o. The figure for 1998 is \$55-billion.

South Africa is at an important junction in regard to the establishment of permitted commercial gaming in the country. The process of developing a casino gambling industry is almost complete; the national lottery is shortly to come on stream, and there has been substantial rationalisation of the horse racing industry. Sports betting is in operation, with policy governing the slot route industry in discussion.

Gaming and the Internet over the past ten years have also experienced exponential growth. Increasingly, policy-makers and gaming regulators are taking the view that to allow unregulated gambling over the Internet is to allow the negative characteristics of gambling to predominate in a medium where usage is growing at an extraordinary rate.

It is common cause among policy-makers and regulators in South Africa that well regulated gaming can serve as a positive contributor to the country's development agenda, serving to improve the economic well-being of South Africans. It is equally accepted that poor, inadequate or absent regulation, however, can squander this potential and cause social and economic harm to the country and its people.

The purpose of this report, commissioned by The National Gambling Board in April 1999, is to investigate the implications for South Africa of the international Internet gaming industry, and to make recommendations so as to

ensure that this new form of gambling exerts a positive and not negative influence on the country's economy and people.

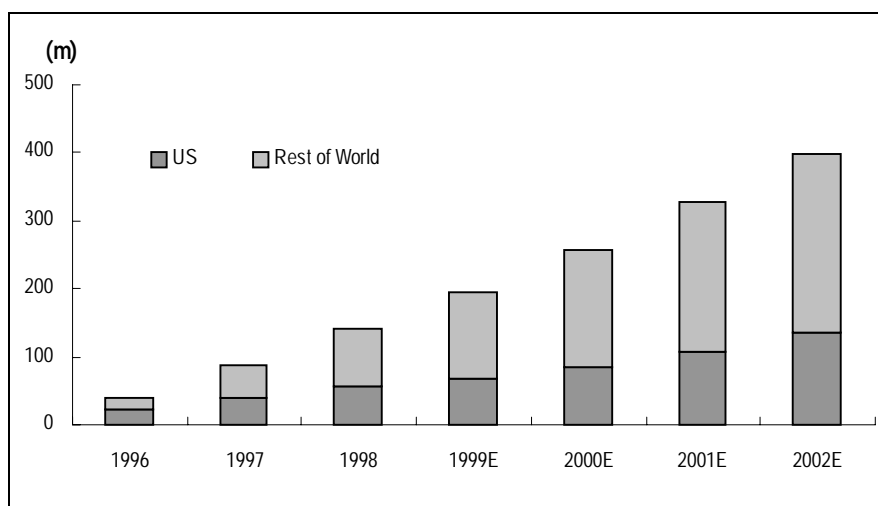
III THE GROWTH OF THE INTERNET

The development of e-commerce as an industry is the leading economic phenomenon of the 1990s. Worldwide Internet usage today exceeds 140-million people, and some experts contend that it will double every hundred days. In monetary terms, e-commerce's value in the world economy already stands at more than \$200-billion, and the International Data Corporation (IDC) estimates that this number will grow to over \$300-billion by the year 2002.

The major reasons for this growth include:

- **PC Penetration** – the large and growing base of PCs in the home and workplace, driven by improved functionality and ease of use, a growing PC literate population and reduced costs of ownership;
- **Technology** – advances in the performance of PCs, modems, Internet access software and communication networks, are dramatically improving the response times and functionality of the Internet;
- **Declining Costs** – more readily available and lower cost access to the Internet, due to technology advances and increased competition from Internet service providers;
- **Content** – proliferation of information, content and services offered on the Internet is self-reinforcing the value of the Internet;
- **Search Engines and Portals** – introduction of sophisticated Internet search engines and, more recently, Portals offering users very easy access to local content and information, increasing the ease of use and relevance of the Internet to users;
- **E-Mail** – consumers desire to join the wired global community via E-Mail.

Chart 1: Global Internet Usage



Source: Merrill Lynch: July 1999

While the largest group of Internet users are currently Americans, the greatest growth potential is outside the United States, notably in the underdeveloped areas of Asia and South America. Already in South Africa there are more than 1-million Internet users, and high growth is similarly expected here.

In particular, because the Internet and digital television mediums are likely to converge in 2001/2, a much larger and broader-based market will come on line in South Africa, with significant growth implications for Internet usage.

The size and economic value of this industry has been recognised by government in South Africa, which is fast-tracking the process of defining a policy framework for the regulation of electronic commerce to ensure that the country does not fall behind the rest of the world[®]. Indeed, it is to be hoped by government that the country will become a world leader in this field.

IV THE GROWTH OF INTERNET GAMBLING

In parallel with the proliferation of Internet usage internationally, and in South Africa, gambling on the net is growing at a high rate. Because the industry is at present illegal in most parts of the world and inadequately regulated in most of the others, accurate statistics of its size are difficult to come by. Even the more reliable ones estimate the value of the industry to be between \$2-billion to \$10-billion per annum[®].

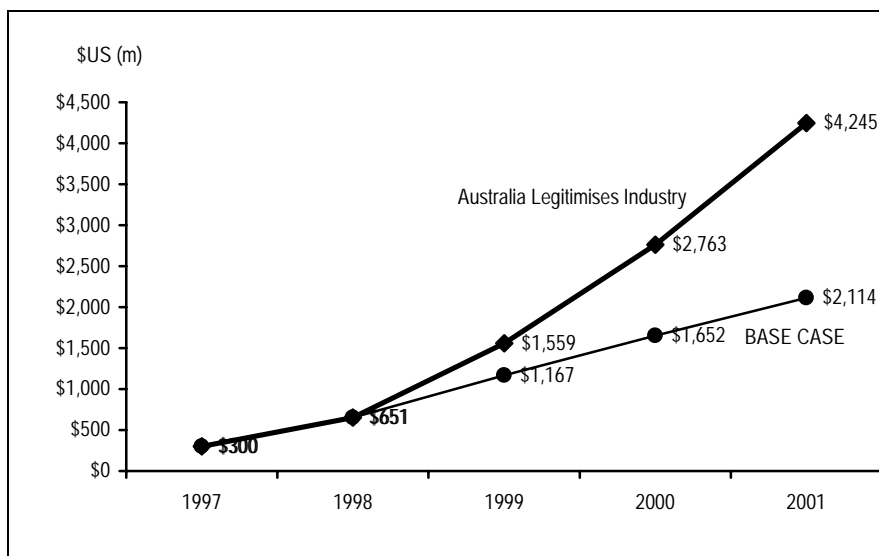
There is little doubt, however, that Internet gambling has already become a significant growth industry, and New York analysts Christiansen/Cummings forecast that revenue derived from this sector of the gaming industry will grow internationally by a substantial compound annual rate of 67%.

Table 1: Internet Gambling Revenue Estimates

Calendar year ended	1997	1998	1999F	2000F	2001F
Adult home Internet users (millions)	46	81	121	145	159
% users conducting on-line transactions	15%	18%	21%	24%	27%
Potential Internet gamblers	6.9	14.5	25.4	34.8	43
Per Capita Expenditure (US\$)	\$146	\$150	\$155	\$160	\$165
Potential Internet Gambling Rev (US\$m)	\$1,009	\$2,189	\$3,923	\$5,554	\$7,106
Estimated Actual Gambling Rev (US\$m)	\$300	\$651	\$1,167	\$1,652	\$2,114
Actual as % of Potential	29.7%	29.7%	29.7%	29.7%	29.7%

Source: Christiansen/Cummings : Merrill Lynch, July 1999

It should be noted that Christiansen/Cummings believe that actual on-line gambling revenue, despite its considerable earnings, is still only achieving just under 30% of the on-line industry's potential. That there is significant potential upside is really beyond debate.

Chart 2: Estimated Actual Internet Gambling Revenue

Source: Christiansen/ Cummings; Merrill Lynch July 1999

Although estimates also vary as to the number of Internet gaming sites internationally, consensus is that there are in the order of 400 sites operational at any given time, some in highly regulated jurisdictions, but the majority not so. Some have been extremely successful, with the racketeering division of the FBI reporting that an Antigua-based operator achieved a turnover in 1998 of \$750-million.

The growth potential of the industry is evidenced by a report published by Macquarie Equities of Sydney, Australia, in April 1999. In this report, Jenny Owen, chief gaming analyst at the firm, wrote:

“The expenditure estimates for Internet gaming are quite conservative. Most at risk are those companies without a strategy to enter this market, and in jurisdictions that will not legalise Internet gaming”.

Brokerage house, Merrill Lynch, in its July 1999 report entitled *“The Internet Gambling Boom – Australian Companies Set To Cash In”*, believes that the industry internationally will develop in two phases:

- Phase One: Current Until 2001

This phase, one of development, is likely to be characterised by a relatively large number of small Internet gambling operators, with less-than-onerous licences which have been issued by countries in the Caribbean, South America, Eastern Europe and the south Pacific.

Growth of the industry in this phase has been tempered by a market perception of lack of probity, compliance and industry standards in regulatory environments widely thought to be inadequate.

- Phase Two: Post 2001

Merrill Lynch believes that exponential growth will occur in the industry from 2001, initially because of the convergence of Internet and television mediums, which means that Internet gaming will no longer be restricted to the computer screen, but will reach a much larger audience through television distribution.

Because of this enormously improved access to Internet gaming, it is already clear that the major international gaming operators will enter the industry, forcing out the small players with their global brand names and multi-media links. Regulatory authorities in the world’s bigger and more established economies will anticipate this gear change in the industry, and will introduce the appropriate probity, legal and compliance measures to regulate this increasingly profitable business.

Internet gambling, therefore, while unlikely to generate more income than the land-based gambling operations of the major players, will definitely become an important earnings adjunct to these companies and countries.

Already, a number of regulatory jurisdictions are busy with, or have completed, the appropriate regulatory framework to legalise Internet gambling, but the strictness of control and regulations varies widely. The Caribbean nations, thought to account for more than half of currently operating Internet sites, have a negative image, while other jurisdictions, at the other end of the spectrum, are regulating and taxing the Internet gaming

industry with a diligence comparable to their stern and close oversight of other forms of gaming.

The Australians are market leaders in this area, and by the end of this year, the majority of jurisdictions in the country will have the appropriate regulations in place. Queensland and the Northern Territory have begun the licensing process, and have issued one licence each. Already Australia has IT suppliers and testing companies at the cutting edge of this industry internationally, and who are increasingly in demand, especially from Canadian and European regulators and operators. Liechtenstein has already introduced an on-line international lottery and hopes to be successful with its "MILLIONS 2000" lottery.

Other credible jurisdictions are in the process of researching or introducing Internet gaming. These include a variety of European and Asian countries, as well as at least two Canadian provinces and countries such as Swaziland. According to the National Gambling Impact Study Commission final report (Chapter 5, page 2 - 3, entitled "Internet Gambling") currently governments in 25 countries licence and have passed legislation to permit Internet gambling operations.

Increasingly, it seems, governments have come to realise the revenue and other benefits of this new industry, especially since it is overwhelmingly one in which earnings are dollar-based and generated from outside the economy and jurisdiction concerned, thus constituting no threat to the indigenous gaming industry. This is evidenced by Deutsche Bank gaming analyst, Lily Kwong, writing in Australia's authoritative *Financial Review* of 4 May 1999:

"Governments should not yield to anti-lobbying groups and miss this window of opportunity, because the bulk of Internet gambling revenue will not be derived from Australia, but will come from overseas and will therefore be a rich source of export revenue for the country."

Only the United States at present seems implacably opposed to the introduction of Internet gaming, despite the fact that more than half of world revenues in the industry accrue from American punters.

Historically, gaming in the US has been an area of state competence, with no federal law which explicitly bans the use of Internet to conduct wagering, except perhaps sports betting.

However, Senator Jon Kyl (R, Arizona) has introduced an updated version of his Internet Gambling Prohibition Act (S692), a proposal similar to a bill Kyl introduced last year which was passed (90/10) by the Senate. The new version seeks to add a new section (S1085) to the 1961 Wire Communications Act to include new betting mediums, such as the Internet, and covers both sports gambling and casino games. However, unlike the previous version, *the new bill will not criminalise individuals*, but will target only site operators and possibly ISPs.

In summary, the bill proposes to:

- Make it illegal for gambling operators and Internet service providers to accept bets from US citizens or residents;
- Fines up to \$250 000 and/or a four year jail term.

The Kyl bill is likely to pass, uniting as it has ordinarily opposing groups such as the problem gambling lobby, America's highly influential land-based casino industry, as well as its lottery owners and operators. Probably as certain is the likelihood (within a relatively short space of time, thought by analysts to be between three and five years), that the bill will be repealed: prohibition has an unhappy track record in the US, and this level of control of the Internet is widely expected to fail due to market pressures.

The implications of the Kyl bill for international jurisdictions, however, are positive in many respects, most notably that countries like South Africa and Australia have a short window period in which to become the dominant players in this lucrative global business without facing competition from the US industry.

V WHAT ARE THE OPTIONS FOR GOVERNMENTS INTERNATIONALLY?

Governments basically have three options in the wake of the proliferation and growth of Internet gaming:

- Adopt a **laissez-faire/wait-and-see approach**, which essentially means to do nothing. Unfortunately, this means unrestricted access to a given jurisdiction for unlicensed or questionable operators, and opportunity lost in terms of earning new tax revenues and foreign exchange;
- **Protectionism/Prohibition**, as is being attempted in the United States. This is ordinarily done in (almost certainly) a vain attempt to prevent the spread of gambling, either on moral grounds, or to protect land-based operators who have paid licence fees for the right to trade in specific geographic areas, occasionally with exclusivity zones;
- **Regulation/Taxation**, as in Australia and Liechtenstein, so that government may access the potentially significant tax revenue of the industry, and at the same time, to provide a fully regulated product to protect the consumer.

Obviously within these categories, there are variations: in Britain, for example, individuals are not prohibited from Internet gambling, provided the site is located outside the country. Conversely, Austrian and Dutch punters can only gamble on the Internet on sites owned by their own nationals, and located within their country's geographic boundaries.

Also, some countries make it a prerequisite that the state should control Internet sites, as in Liechtenstein, while others (as Canada are planning) intend

to make it illegal for government to be any way involved in the ownership or management of Internet gaming.

VI WHAT POLICY SHOULD SOUTH AFRICA ADOPT?

If South Africa is to develop Internet gaming as an export industry its policy needs to achieve two objectives:

- First, it must position itself internationally as the most attractive jurisdiction for suppliers of Internet gaming services.
- Second, it must ensure that its regulations offer levels of player protection which are widely acceptable to foreign governments and which, in due course, may be expected to be incorporated in some form of international agreement.

The global environment in which South Africa would be regulating Internet gaming is the following:

USA

The USA will prohibit Internet gaming at least for a few years. The Kyl bill will probably be passed in some form banning Internet gambling. The impulse for this comes to a crucial extent from land-based gambling companies seeking a period of protection for their existing operations. However, it is also reinforced by the current hostility to gambling among significant sections of US society.

EUROPE

It is difficult for any major European country in the short-term to set up internationally-competitive Internet gaming operations because of “harmonisation” policies, particularly in relation to tax, between member states of the European Union. They are therefore concentrating on agreements which will require individual countries only to licence providers of services for their own nationals. (See Appendix Two for the agreement drawn up by the European Gaming Regulators Federation – “GREF.”) The GREF agreement covers the following issues:

- meet high standards of probity;
- are effectively and efficiently monitorable by, and in, the licensing jurisdiction;
- don’t cheat or mislead players;
- don’t launder money;
- ensure the safety of players’ deposits and winning;
- effectively exclude underage gamblers;
- have effective strategies for dealing with compulsive gambling
- have sensible rules about granting credit;

- have sensible rules about advertising;
- protect the players' privacy and right to confidentiality;
- ensure security of data transmission;
- have honest methods for generating random numbers.

AUSTRALIA

Australia is pioneering respectable regulation but, in our view, is erring on the side of unduly high and unattractive tax rates. Also the industry in Australia may suffer from inter-provincial competition, the lack of a coherent national policy, and monopolies enjoyed by Australian licensees in certain types of gaming.

ASIA/PACIFIC

There are early signs of interest in this business among governments in the Far East, notably Thailand and the Philippines, but their progress has been slow due to delays in re-working these countries' overall legislative environment for gaming.

OTHER

The Caribbean countries, especially Antigua, are seeking to become more respectable but at present do not inspire great confidence in potential gamblers. The perception is that it is unacceptably easy to obtain a licence from these jurisdictions, which some define as "lightly regulated", and others compare to illegal operations, especially to the extent that they serve US citizens. Antigua, for example, is still suffering from the repercussions of a controversial Internet bank failure.

SOUTH AFRICA

However the competitive advantage which this happy concatenation of circumstances bestows on South Africa cannot be expected to last for more than a few months. This means that South Africa must act *quickly* in creating the best possible jurisdictional environment for attracting both the suppliers and the customers of Internet gaming. In this respect it is encouraging that the Government has already decided to fast-track the regulation of e-commerce in South Africa.

The key to successful Internet gaming regulation will be to create an environment which has all the advantages in terms of simplicity and low costs of the Caribbean (but without the questionable reputation) and all the advantages in terms of international respectability and player protection of Australia (but without the high costs).

The principal issues to be addressed in formulating good policy, good law and good regulations for Internet gaming out of South Africa are:

- amending national legislation;
- making regulation a responsibility of the National Gambling Board;

- good policy in relation to taxation and other benefits to the people of South Africa;
- licence fees;
- player protection;
- underage gambling;
- international recognition;
- strict regulation to eliminate crime and money laundering;
- South African citizens
- banking issues;
- monitoring to ensure the integrity of games and accounting;
- licensing requirements and process.

6.1. Amending National Legislation

Given the need for speed and simplicity, we believe that the regulation of legal Internet gaming in and from South Africa should be provided for, as expeditiously as possible, by an amendment to the existing National Gambling Act.

6.2 Competence And the National Gambling Board

We believe that Internet gaming should be a national rather than a provincial competence and, therefore, regulated by the National Gambling Board. This is because:

- A successful Internet gaming industry is primarily dependent on the generation of international trust;
- Regulations endorsed and administered by the South African Government will be perceived internationally as more authoritative than if the same regulations were administered by nine different Provinces;
- Australia is already experiencing difficulties as a result of leaving Internet gaming to regulation by each of its states because inevitably the states wind up competing against each other;
- Internet policy is really part of a project in international commerce, aimed at securing significant export earnings for the South African economy, and as such should be governed by national policy;
- The National Gambling Board is already established and is the repository of the collective South African experience and skill in the area of gaming regulation.

6.3 Taxation and Other Benefits to South Africa

Because Internet gaming is to be an export business, South Africa should seek to attract as many companies as possible to locating themselves within its jurisdiction as possible. The competitive market which this will create, will have the further advantage of bringing to South Africa the best, most customer friendly, and most cost conscious technology. This will have desirable spin-offs for other IT-based areas of South African business.

The key to sound taxation policy in respect of attracting Internet gaming companies to locate their businesses in South Africa is to tax company profits rather than transactions via a levy on either bets placed or on winnings.

Ideally South Africa will keep the nett costs of doing Internet gaming in South Africa as low as possible, seeking to maximise the country's profits by attracting as much new business to South Africa as possible. These costs must, at least, be lower than in Australia and should not be uncompetitively greater than Antigua's.

If the taxable profits of Internet gaming out of South Africa are a conservative R1-billion p.a. then at 30% the Government will earn R300-million in new tax revenues.

It should additionally be possible – and even desirable - to raise a small levy on turnover (of probably not more than 2%) as a contribution, for example, to broad-based empowerment through a National Internet Development Trust, or as an earmarked contribution to enhancing the employability of the unemployed by funding computer literacy programmes.

6.4 Licence Fees

Licence fees should be payable to the National Gambling Board to subsidise the Board's administration costs and, perhaps, to include a contribution to a national programme for addressing problem gambling. The Board might conservatively expect to raise R24-million p.a. in this way in year one, and R6-million annually, based on only ten awarded licences.

6.5 Player Protection

Adequate measure to ensure player protection is the most important issue for securing international legitimacy for a South African regulatory regime. In line with best international norms and standards we set out fairly detailed proposals for player protection at Sections 7.1-7.1.1.6 of this document.

6.6 Underage gambling

There is only so much that anyone can do to prevent minors from doing things which it illegal for minors to do. Internet gaming is no exception, and regulations cannot attempt, for example, to legislate to prevent children from using and abusing their parents' credit cards and/or identity documents. We believe that the type of regulation we propose in this regard at 7.5 will be eliminate all but those cases which are analogous to a child's stealing a parent's ATM card, acquiring their pin number and fraudulently withdrawing cash.

6.7 South African Citizens

A separate policy issue which needs to be considered, is whether and, if so, under what circumstances, to allow South African citizens to gamble on the Internet. The available options are:

- to exclude them entirely
- to permit them to play but to tax them at the same or at higher rates than participants in the different forms of land-based wagering; or
- to permit them to play on the same basis as foreigners.

It could be argued that South Africans should be excluded so as not to increase the locally available amount of gambling in which they can indulge, perhaps to their detriment. However, what is demonstrably true, is that currently, a relatively small proportion of South Africans have the financial and other resources to have access to the Internet.

For the foreseeable future, or at least until television becomes a medium through which Internet is available, only a small number of South African residents will have access to Internet gambling. This medium, therefore, is not likely to increase the incidence of addictive gambling behaviour to any serious degree.

The case for taxing them, while not taxing foreign bettors, is that this provides equity to land-based gaming operations and it may be necessary for the National Board to accommodate the sensitivities of other stakeholders in the South African gaming industry by imposing a tax, which should be not less than that applicable to land-based casino gaming.

The case for treating South Africans the same as everybody else is mainly that otherwise they will simply gamble with foreign-based operations.

We acknowledge the force of all these arguments, but believe that the case is strongest for taxing South African players on the basis that they are gambling in South Africa. We would stress, however, that South Africans are most unlikely to constitute even as much as 2% of the market. It would consequently be most unfortunate if the export opportunity were lost because of disputes about this issue.

6.8 International Recognition

South Africa's regulations, in order to confer respectability on licensees and therefore to instill confidence in customers, will have to conform to the principles agreed by GREF, as well as those articulated by the Australians. These are set out at Appendix Two and Three of this document.

Plans should be made to formalise mutual recognition of key player protection issues between as many leading jurisdictions as possible.

6.9 Crime Prevention

Prevention of crime in relation to Internet gaming is a matter of independently ensuring the integrity of all electronic systems to avoid fraud; of protecting player privacy to avoid improper use of information, e.g. for purposes of blackmail; and of preventing money-laundering. The regulations we propose address each of these concerns. An input from the SAPS would probably be valuable in this connection.

6.10 Banking Issues

It will be imperative that the Reserve Bank advise and agree on any issues concerning foreign exchange regulations which may be relevant. It will also be important that South African licensees demonstrate to the Board that they have made adequate arrangements with respect to on-line banking transactions. It should also be noted that money-laundering is primarily an issue of good banking regulations in respect of monitoring and reporting large and unusual transactions.

6.11 Licensing Requirements

As in Queensland, and other credible regulatory jurisdictions, we believe that good policy will set reasonably high entry hurdles for would-be operators of Internet licenses in terms of:

- Probity, where licensees should meet internationally-acceptable criteria;
- Financial soundness. In particular we believe licensees should be able to meet capital adequacy requirements analogous to those required of commercial banks. It may be worth considering that licensees should be required to deposit moneys to a trust fund which would be used to pay customers in the event of a dispute being settled in favour of the customer, or in the event of the licensee becoming insolvent
- A high level of IT involvement and participation, as well as integrity in all games and technology.

All those who meet these requirements should be able to secure an annually renewable license, with probity clearance being updated every three years.

There should be no specific limit to the number of licences which the National Board can award. Rather, the number of licences should be determined by the high standards and quality which the Board will demand and expect of applicants for a licence.

There is also no point in respect of Internet gaming in having a competitive licensing process for the award of a limited number of licenses because there is no exclusivity which is in the gift of the licensing authority.

It should also be noted that the absence of a competitive licensing process, and the presence of clear and public licensing criteria, will have the further advantage of minimising all motivation and opportunity for seeking to subvert the process, suborn officials or to make allegations of such conduct in pursuit of unlawful competitive advantage.

VII PRINCIPLES FOR THE REGULATION OF ONLINE GAMING IN SOUTH AFRICA

Even more than other forms of regulated gaming, Internet gaming has to be a partnership between the public and private sectors. In land-based gaming this partnership is often tacit and relates mainly to the generation and sharing of gaming profits by and between the two sectors. With Internet gaming, the partnership has to be more explicit. This is partly because Internet gaming will be in South Africa primarily an export business but also because one of the operators' main commercial assets will be the ability to offer their customers the comfort of knowing that they are operating out of a well-regulated and trustworthy environment.

These regulations should be internationally respected, which will result from a powerful independent gambling board in a national jurisdiction that has developed expertise in gambling regulation. The regulations, however, should not be so onerous that they require a costly infrastructure to enforce, involving hundreds of pages of unnecessary regulations and specifications, and a team of experts to explain them.

With proper regulation, South Africa can become the leading worldwide regulatory authority, granting internationally-credible licences only upon proof of suitability and giving no advantage or monopoly, to any applicant, either domestic or foreign.

South Africa may wish to eventually join with other countries to form a network of regulated Internet markets. In fact, this possibility has been noted by the former President of the North American Gaming Regulators Association, Frank Miller, writing in the February 1999 issue of *Internet Gaming International*:

“At some point you will see jurisdictions, such as Queensland, South Africa, and many smaller nations coming together to form a network of regulated markets. Someday the United States will need to join such a framework”.

There are a number of essential features which ought to characterise efficient and enlightened regulation of Internet gambling in South Africa:

7.1 Player Protection

7.1.1 A control system needs to be established by the licensee, which will be approved by an independent testing house, appointed by and responsible to the Board, but with costs covered by licensees. This control system must accommodate at least the following:

7.1.1.1 The operation of an adequate and secure Random Number Generator, which ensures the fair operation of the games and the determination of a result which cannot be manipulated by the operator;

7.1.1.2 The establishment and operation of player accounts, which includes:

- The pay-out of credit balances without delay;
- The furnishing of a full accounting by the operator to the player on demand; and
- The inability of the operator to tamper with the system or the result of games.

7.1.1.3 Periodic audits shall also be performed by the audit staff of the Board and routine inspection by the Board's agents shall be done to ensure the integrity of the above.

7.1.1.4 Minimum Standards: the Board may initiate standards requiring minimum payouts (eg. 85% - 90% payout for slots games), the prohibition of a near miss, and prohibition of certain kinds of advertising.

7.1.1.5 Verification of Advertising, Marketing and Warranties
The Board shall verify any warranties of a licensee concerning minimum payouts of slot machines (eg 85% to 90% payout)) and shall prohibit misleading or deceptive gaming practices.

7.1.1.6 In order to ensure the proper functioning of the system and in order to audit its operation in a working environment, operators ought to be prohibited from offering money prizes until they have operated their systems in a live environment for points for a period of about three months.

7.2 Financial Solvency

All applications must provide proof of financial solvency. The financial stability of the operator must be established through a bond or trust/escrow account, backing by an outside financial entity, insurance for large payoffs and insurance for errors and omissions.

The Board may also require operators to deposit moneys into an interest-bearing trust fund, administered by the Board, sufficient to meeting any gaming debts which the licensee may have outstanding in the event that a complaint against the licensee is upheld by the Board's independent appeals procedure or in the event of the licensee becoming insolvent.

7.3 Dispute Mechanisms

In the case of aborted games, the Board shall establish regulations for mid-game interruption by the operator, player or failure of the licensee's system.

The usual mechanism for resolving these issues is by ensuring that the game is resumed and completed when the player next logs into the system, prior to any further activities by that player being undertaken.

Players must be able to register complaints with the operator, which should be dealt with expeditiously. Furthermore, an appropriate complaints-resolution mechanism must be provided, through the

establishment of an independent ombudsman's office to adjudicate complaints relating to the industry.

7.4 Player Privacy

The Board shall ensure privacy issues by prohibiting the use of lists or names of registered players from not being used for any other purpose than to verify the player and player's location.

To maintain adequate protection of individual privacy, there must be ensured: player anonymity during the reporting process to the Board; and the electronic and physical security of the operator's system.

7.5 Underage Gambling

7.5.1 A strict system should be devised and implemented for player registration, prior to the player being entitled to gamble on the system. This should provide a reasonably adequate assurance of the identity of the player, but should not be so impracticable as to render the system undesirable for participants.

7.5.2 The implementation of a short waiting period prior to initial play may be the most feasible way to ensure that players have been screened properly. During such a waiting period, the operator would have the opportunity to verify age and whatever additional information is necessary to ensure that the site is not being used by under-aged participants.

7.5.3 Penalties shall be imposed on licensees who negligently accept bets from under-aged.

7.5.4 Access must also be given through the site to software which assists in excluding minors from the site (eg. Net-Nanny etc).

7.6 Problem Gambling

7.6.1 Provision must be made for the voluntary exclusion by self-excluded players from the system (eg. by electing to be excluded three times).

7.6.2 The player must be given access, from within the site, to information and other sites dealing with problem gambling.

7.6.3 Penalties shall be imposed on a licensee who negligently accepts wagers from individuals who have self-excluded themselves as problem gamblers.

7.6.4 Players shall be required to stipulate in advance a maximum amount that they are to be allowed to lose in any one twenty-four hour period. Licensees are required to abide by this and to require twenty-four hours notice before this daily limit can be increased.

It should be noted that the incidence of problematic or addictive gambling behaviour is more easily detectable in an Internet gambling environment because mandatory player tracking, accompanied by strict player identification, is central to gambling operations in this medium.

The physical controls in a land-based environment are much less precise and certain.

7.7 Money Laundering

Regulated Internet gambling will have stringent account establishment rules, and audit trails, which will discourage the criminal element from trying to wash illicit or unexplained income.

With everything on line and recorded in central computer, the Board will be able to monitor games more easily, for example, than a blackjack table in a real casino. *All* bets and pays will be recorded.

In order to minimise further money laundering, there must be full transparency in respect of the transactions conducted on the operator's system. To this end, details of every transaction must be accessible by the Board, either in full or in summary form.

Along with debit cards and digital cash transactions, credit card transactions must be permitted, but the operator is to be precluded from granting the credit approval. In other words, the operator will be obliged (as would any merchant offering credit card payment) to refer the credit approval decision to the relevant credit card company, prior to permitting the player to gamble.

Players will only be permitted to gamble if and to the extent that their accounts are in credit.

The Board will be permitted to insist upon the freezing of any activity on a particular player account, in certain pre-defined circumstances.

7.8 Probity

Probity investigations will need to approve licences of potential gambling operators, key employees, and creators of gaming software who must submit proof that they (individual and corporation) and parties with a level of financial interest in the operation are suitable for an Internet gambling licence.

Weight may be given to a finding of suitability by a foreign regulatory body such as the Gambling Board of Great Britain, Queensland or other impeccable gaming authorities.

A gambling licence shall be considered a privilege, which may be revoked for, *inter alia*, a violation of law.

There are two other developments which can be confidently anticipated in relation to Internet gaming and which sound regulatory policy should provide for:

- It is clear that the market for all forms of Internet use will dramatically increase as technology allows people to access their Internet via ordinary television;

- It is also clear that regulations relating to Internet gaming will need to cover:
 - traditional casino games;
 - sports betting including spread betting;
 - horse-racing;
 - megaprize games including lotteries, linked jackpots and football pools;
 - games of dexterity which will grow out of, and for the benefit of existing TV and computer games;
 - new intellectually challenging games as recreation for the intelligent, eg trivial pursuit games, word games etc;
 - Internet games of bridge, poker, monopoly etc where the house takes a fee for arranging and administering the game.

It should be noted that with the development of these new games for a computer literate market, the role of gambling as an activity, which is motivated predominantly by the desire to win money or other goods on games of chance, will be replaced by gaming proper where the motivation is the pleasure of playing and the gambling component is really only a way of paying a participation fee.

Related to this, it may be relevant that in order to protect itself against losses the House will increasingly have to make its money by taking a percentage of the moneys wagered (or other fee) for enabling players to compete against one another rather than setting up the games so that the players play against the House where the House always has a percentage advantage.

VIII TAX AND FINANCIAL ARRANGEMENTS

The pre-eminent aim of legalising Internet gambling in South Africa must be to contribute positively and meaningfully to economic development in the country. This goal is consistent with the objectives of the National Gambling Board, the 1996 National Gambling Act, as well as GEAR and other government macro-planning policy positions.

In order for South Africa's Internet gambling industry to accomplish these aims, it is essential that it should be internationally competitive.

To encourage, therefore, the development of the industry toward this end, it will be necessary to incentivise international operators to locate their businesses in South Africa. As discussed earlier in this report, the first step is to ensure that the country has a credible regulatory framework. Secondly, it should put in place an attractive tax and financial régime.

Together, these two prerequisites will do much to ensure that the country can become the leading worldwide centre of the \$7-billion international industry of Internet gaming.

Tax régimés differ from country to country. Antigua, for example, has attracted considerable numbers of Internet gaming operators by virtue of the fact there is no taxation over and above customary corporate tax. Australia, on the other hand, has imposed a very high level of taxation (50%, in most states except the Northern Territory, which stands at 8%, and Tasmania at 15%).

South Africa's opportunity, therefore, is to make its tax régime more attractive than that of Australia, and European countries, relying rather on a large number of operators paying corporate tax to the local exchequer, rather than a small number of operators paying a high level of gaming levies.

In order to do this:

- 8.1 Ordinary corporate tax (30%) should be levied, in itself a rich source of revenue for government, given the \$7-billion gross size of the global industry;
- 8.2 Over and above corporate tax, the question of the imposition and extent of a gaming levy will have to be determined as a policy issue. In this regard, additional factors to be taken into account are:
 - 8.2.1 the added cost of operation created by such a levy, and the consequent difficulty in attracting foreign operators;
 - 8.2.2 However, a low levy (of the order, for example, of 2% of player losses) could be imposed on operators specifically for social purposes, and not as a tax. Revenue raised in this manner could be collected and administered by the National Gambling Board as a development trust fund to encourage IT education among the historically-disadvantaged, as well as to stimulate the development of black-owned IT firms.
- 8.3 The basis and procedure for securing co-operative arrangements with other comparable jurisdictions is important and will have to be defined;
- 8.4 The inter-relationship between the conduct of the games and the relevant exchange control provisions will have to be secured and defined. The mechanics of this relationship are to be the product of policy debate and inter-departmental negotiation and co-operation by National Government;
- 8.5 An annual licence fee, application fee, as well as an initial licence fee, must be provided for. Appropriate by international standards, and payable directly to the regulating authority (the National Gambling Board), might be the following fees:
 - 8.5.1 Application fee: US\$ 50 000
 - 8.5.2 First-year licence fee: \$350 000
 - 8.5.3 Renewable annual licence fee \$100 000

Probity costs, as per precedent, should be charged as extra to applicants.

IX CONCLUSION AND RECOMMENDATIONS

Internet gaming offers the South African government a unique and potentially very lucrative business opportunity in the domain of international commerce. If it is to exploit this opportunity, however, it is imperative that South Africa proceed with the greatest possible haste to implement the legalisation and regulation of Internet gaming so as to create an environment for operators which is highly attractive by comparison with other jurisdictions. Such an environment must also meet the highest international regulatory standards in respect of player protection and probity requirements. We believe that the South African National Gambling Board should set itself the target of issuing the first licences in the first quarter of the next millennium.

In concluding this interim report, we recommend as follows:

- That the National Gambling Board adopt the introduction of a legal and well-regulated Internet gaming industry in South Africa as a high priority project, to be planned, regulated, co-ordinated and, in due course, administered by the National Gaming Board under an amended National Gambling Act;
- That the National Gambling Act be amended as to permit wagering and gaming to be conducted over the Internet, subject to such regulations as may be promulgated by the responsible Minister in National Government, and such licensing procedures as may be required by the National Gambling Board.
- That the Board and its principal stakeholders comment upon this report and make recommendations to its authors on what needs to be done to finalise this report as a comprehensive document which can be adopted by the Board and presented to Cabinet, via the Department of Trade and Industry. Ideally, the completed report should pre-empt all possible occasions for political controversy and bureaucratic delay;
- That the National Board should proceed to explore the best ways of achieving recognition of its policies and regulations by comparable international jurisdictions, especially those on Australia, Europe, and Canada.
- That the National Board should facilitate, as a matter of urgency, discussions of this project by the Cabinet of the National Government, and in particular, as needed with the Ministries of Finance, Foreign Affairs and of Posts, Telecommunications and Broadcasting, in addition to the Department of Trade and Industry.
- That the National Board should establish a provisional timetable, with a critical path and deliverables, so as to ensure that the various stakeholders and role players keep to a schedule which can see South Africa trading in this international industry by no later than the end of the first quarter of the year 2000.

APPENDIX TWO

The Gaming Regulators European Forum (GREF)

At its annual meeting in Helsinki in May 1998, GREF adopted a preliminary position on Internet gaming. In summary, it takes the following form:

The Gaming Regulators European Forum consists of representatives from gaming regulatory organisations throughout Europe. Its two main objectives as stated in its constitution are:

- a) to provide a forum in which European gaming regulators can meet, exchange views and information and discuss policy on gaming matters; and
- b) on special occasions and with the agreement of members represent the different views of European gaming regulators and also provide a central point of contact for enquiries directed at them from authorities or related organisations in Europe and elsewhere.”

At its meeting in Helsinki in May 1998, the Forum agreed this position statement on Internet gambling. As an association of experts in gaming regulation, it offers the statement as a set of recommendations of good practice for the consideration of the appropriate regulatory bodies and Governments of individual member countries, whether at national or autonomous regional level. It acknowledges that the countries will wish to consider, and if necessary adapt, the statement in the light of their particular legal, social, cultural and economic circumstances.

GREF currently regards the regulation of gambling (that is gaming, betting and lotteries) as a matter for the competence and jurisdiction of individual countries, in the light of their particular social, cultural and economic conditions.

It therefore follows that it is a matter for individual Governments, either at national or autonomous regional level, whether or not they wish to permit any forms of gambling to be offered on the Internet in their territories and, if they do, under what circumstances or conditions particular forms of gambling are to be allowed. For now, this means that member countries will respect decisions made by other jurisdictions in Europe, but there is clearly a movement – growing stronger it seems to me – to take GREF to a level where a common policy approach is adopted.

This is being justified by all the wrong reasons, such as taxation policy, crime, etc. As you can see in Point 3, there are early signs of this.

3. If a jurisdiction is to permit forms of gambling to be offered on the Internet, the members of GREF regard it important that:

- I. those to be permitted to offer such forms of gambling should be subject to the same level of investigation and probity and other checks as is applied to traditional, terrestrial gambling operators.
 - II. those so licensed should be required to establish their operation in the territory of the jurisdiction concerned so that the operation can be properly controlled and policed.
 - III. the gambling so offered should be restricted to residents of the jurisdiction concerned and residents of such other jurisdictions with whom there are co-operative or reciprocal arrangements.
4. As a matter of good practice, those permitting such gambling should also address such issues as:
 - the methods to be used to ensure that such operations are fairly conducted and the players are fully aware of the rules that apply.
 - The methods of ensuring that such operations are not used as a means also of conducting illegal activities, in particular for money laundering.
 - The permitted arrangements for paying for wagers on the gambling offered, including restrictions on the granting of credit.
 - The methods protecting and guaranteeing the funds deposited and the monies won by the players.
 - The means of ensuring that no players are under the legally permitted age for the appropriate form of gambling in the jurisdiction concerned.
 - The means and level of protection to be offered to compulsive gamblers and others who may have difficulty in controlling their gambling
 - The controls to be placed on advertising, particularly in respect of jurisdictions which do not permit such gambling or do not welcome such advertising.
 - The methods to be used to protect the privacy of the players and the confidentiality of the information provided by them.
 - The methods to ensure data protection and security of transmission.
 - The methods to be used to ensure that tests and checks are conducted regarding the randomness of the games and, including EDP-audits, regarding the electronic gaming systems used by the operators.
 5. In considering whether to permit gambling operations on the Internet, GREF believes it will be necessary to distinguish between those who simply seek to offer an alternative means of access to existing permitted terrestrial gambling products and those wishing to establish separate, new forms of gambling opportunities. In either case, consideration of the types of issue raised above is likely to be needed.
 6. If a jurisdiction wishes to prohibit cross-border gambling on the Internet for its residents, and consequently wants to prevent the import of such gambling, it will probably need to do so by means of legislation preventing service providers from

transmitting the offer of such facilities, rather than by means of prohibitions on individual residents of those jurisdictions from taking up such facilities.

In support of this, consideration will be given to the possibility of requiring licensed Internet gambling operators to include in the contracts with their service providers a condition that the latter will prevent access to addresses of foreign (illegal) operators of Internet gambling in so far as the service providers can be expected to have notice of those addresses.

The meeting in Helsinki was attended by regulators from 15 countries (Estonia, Denmark, Finland, Germany, Great Britain, Hungary, Ireland, Netherlands, Norway, Poland, Portugal, Slovenia, Spain, Sweden and Switzerland)

APPENDIX THREE

Australia's National Draft Regulatory Model for Internet Gambling

The Federal Government believes the best way to deal with Internet gambling is to regulate it. Supporters of regulation state the best way to ensure fairness, credibility and accountability is through licensing, regulation and enforcement. They argue that prohibition of Internet gaming and wagering would create a situation similar to what happened in the US with alcohol in the 1920s. They argue prohibition would force reputable businesses to close, while opening the industry to less legitimate operators and depriving local and federal governments of potentially attractive tax dollars.

By monitoring operators and forcing them to adhere to **a code of conduct or compliance**, proponents argue customers would be protected with transaction records, consistent odds, sufficient capital available for payouts and safe fund transfers. In an ironic twist, proponents also argue that the technology involved in operating Internet gaming sites is better suited to recognizing and monitoring problem gamblers than that which is available in traditional casinos today.

A national draft model on key points to consider with respect to the regulation of Internet gambling was drawn up as a co-operative enterprise between the States and Territories in 1997. The goal of the proposed legislation was to have a unified approach to regulate Internet gambling, as opposed to attempting to prohibit it.

The draft national regulatory model was designed to protect consumers, and to provide Australian companies the opportunity to obtain a global market share supported by an effective and accepted Internet gaming regulator.

The key elements of the draft national regulatory model are as follows:

- Operational controls over each product will be technology based using similar principals to those used to control and regulate distributed gaming machine networks.
- Each product and service provider will be required to demonstrate that the system provides effective protection of player entitlements and can be easily audited.
- Audit and inspection powers will be developed mirroring Australian casino and gaming machine operations.
- Ability of the regulatory body to appoint an agent to receive and forward complaints to the appropriate regulatory body. Service providers must maintain privacy of player information.
- Taxation applied on the basis of location of residence of the player and will be remitted to the player's jurisdiction. For non-residents in participating jurisdictions who access the product, the tax will be retained by the jurisdiction in which the server is located.
- Ability to identify origin of location of player and to collect, verify and provide audit trail to determine that the appropriate amount of tax is remitted to the required jurisdiction.

- Players to open account and register details such as proof of identity, age and place of residence.
- Service providers required to institute identification of players at time bets are accepted such as personal identification number or password.
- Prohibition on minors gambling.
- Credit gambling will be prohibited.
- Provisions directed at problem and compulsive gambling players. Must have ability to set maximum bet levels or maximum total bets. Persons will be allowed to self-exclude themselves. A self-exclusion will only be lifted on seven days notice. Service providers will be required to make available information on contact points for problem gambling services.
- Anti-money laundering service providers to report to AUSTRAC.

The Federal Government is prepared to **provide a framework for the legislation but is not prepared to enact the legislation**. The Federal Government is reluctant to interfere in what has traditionally been a State Government responsibility. Hence it has been left to the individual States as to whether they choose to introduce the legislation or not.

Canberra has also asked the **Productivity Commission** to produce a report on gambling, including Internet gambling (the draft of which is being released at the time of writing). Submissions to the Commission by Australia's major gambling businesses say excessive taxation and regulation are barriers to competing with Internet gambling. Crown, Star City, Jupiters, TAB, Tabcorp and Tattersalls collectively stated that State Governments need to deregulate the industry before consumers become comfortable with "unregulated" online gambling. Their submission criticises the "imbalance" between Australian Government taxing and offshore levies.

¹ Eadington W. – “*Gambling – How much is enough?*”

² Business Day – 30 July 1999.

³ Christiansen/Cummings, as quoted in Merrill Lynch: - “*The Internet Gambling Boom – Australian companies set to cash in*”.