

DAVE FROHNMAYER
ATTORNEY GENERAL



JACK L. LANDAU
DEPUTY ATTORNEY GENERAL

DEPARTMENT OF JUSTICE

Justice Building
Salem, Oregon 97310
Telephone: (503) 376-4100

October 15, 1991

Debbs Potts, Chair
Oregon Lottery Commission
754 N.E. Madrone Street
Grants Pass, Oregon 97526

Jim Davey, Director
Oregon State Lottery
2767 - 22nd St., S.E.
Salem, Oregon 97302

Dear Gentlemen:

This responds to your request that our departments review and comment on the Oregon State Lottery's proposed administrative rules and preliminary operating plans and procedures to implement a video lottery system in Oregon. We sincerely appreciate the opportunity to comment and make recommendations concerning the security aspects of any such system.

At the outset, we wish to state the obvious: the most secure system is no system at all. One of the premiere features of HB 3151 -- indeed, the only valid point in selling it as a "law enforcement bill" -- is the ban on existing video gambling machines. This ban on so-called gray games takes effect on December 1, 1991. Strict enforcement is expected and there will be no grace period for compliance.

But please do not believe that concerns of the law enforcement community go away when the existing machines go away. The concerns simply become different concerns. This observation is based on several propositions.

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First, no system of statutes and rules regulating legalized video gambling can avoid the probability that criminal interests will try to infiltrate the operation of the system or the probability that new criminal activity will spring up around the edges of the lottery system. Second, investigation of any criminal activity will be as expensive, technologically intensive and as difficult as the most complex investigation of any gray game scheme. Third, these dangers are enhanced in direct proportion to the extent that private interests are involved in the operation of the system.

These propositions are not offered lightly. These observations are based on years of law enforcement expertise in Oregon and in consultation with our colleagues around the country.

We recognize that you are charged by the Constitution and statutes to establish and operate a state lottery to create jobs and further economic development. We are charged with law enforcement and the protection of the public. In its simplest terms, your job is to make money; our job is to help ensure that the State of Oregon is running clean, honest games.

To that end, the career professionals in our departments reviewed the proposed rules and preliminary operating procedures developed by the Lottery staff. While the enclosed report recommends added security measures, one recommendation -- sure to generate controversy and debate -- deserves special emphasis.

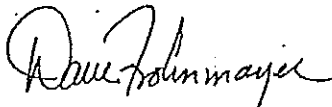
In the strongest possible terms, we recommend against the involvement of independent operators in any state-run video lottery system. The commission will be subjected to intense pressure to allow independent operators to participate. But as Director Davey stated on many occasions before the Oregon legislature and elsewhere, the fewer parties involved between the player and the Lottery, the more the system is secure. The mere hint of any impropriety puts the entire Lottery at

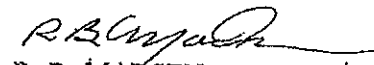
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risk. Bluntly stated, this commission cannot and should not transfer its security responsibilities to private operators. The law does not require it and the Lottery should not permit it.

We wish formally to acknowledge Oregon Lottery staff members for their open and candid assistance in this review. We are available to answer any questions or concerns. As the video lottery system develops and evolves, we stand ready to advise the commission and its staff on further security measures.

Sincerely,


DAVE FROHNMAYER
Attorney General


R. B. MADSEN
Oregon State Police
Superintendent

Enclosure
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REPORT and RECOMMENDATIONS
to the
OREGON LOTTERY COMMISSION
REGARDING PROPOSED VIDEO LOTTERY SYSTEM
SECURITY MEASURES

Oregon State Police
Department of Justice

October 1991.

INTRODUCTION

On August 13, 1991, Oregon State Lottery Commission Chair Debbs Potts and Oregon State Lottery Director Jim Davey requested the Department of Justice and the Oregon State Police to jointly review the Lottery's preliminary plans for operating a video poker system. In their letter of request, Chair Potts and Director Davey stated, "The Governor has indicated her desire to have the most tightly controlled security-conscious video lottery system in the country. The Oregon Lottery intends to have the most secure lottery system and requests your assistance to see that this becomes a reality."

As a result of the request, the Oregon State Police assigned Major Dean Renfrow and Lieutenant John McCafferty to review the Lottery's preliminary plans and to coordinate their recommendations with the Department of Justice.

SCOPE OF REVIEW

The Oregon Lottery staff preliminary plan contains 14 exhibits that have been reviewed by Major Renfrow and Lieutenant McCafferty. In addition to the plan review, numerous law enforcement agencies, state and federal were contacted. Contacts also were made with security officials of video lottery systems in other jurisdictions. Some information by necessity will be limited in detail due to the need of confidentiality in ongoing investigations in other jurisdictions.

The security of the system itself was addressed during the review. Law enforcement problems which are likely to arise as a result of the operation of a video lottery system, even on which is internally secure, also were within the scope of the review.

SUMMARY OF REVIEW AND RECOMMENDATIONS

The nation's leading expert on video lottery devices was consulted. His comments included:

- * Operate a state-owned system.
- * Utilize an on-line system with dedicated lines.
- * Use bill acceptors rather than coin operated machines.

Oregon State Police officers inspected video lottery system in New Brunswick and Nova Scotia. The inspection revealed:

- * Gray machines continue to be used.
- * Gray machines are found in many areas accessible to the general public.
- * It has been difficult to prevent operators engaged in unlawful gambling from participating in the lottery system.
- * No operator has ever provided any assistance in the elimination of gray games.
- * The lottery system used to launder "dirty" money.

Oregon State Police officers contacted law enforcement officials in several jurisdictions. These contacts showed:

- * Nevada authorities recommended that operators be excluded.
- * Numerous Oregon operators have been prosecuted by the Oregon Department of Justice.
- * Video machines manufactured by a business alleged to be controlled by traditional organized crime have been seized in Oregon.

The facts support the following recommendations:

- * Strict enforcement of ban on gray games.
- * No private operators be allowed.
- * If operators are allowed, exclude those who have been involved in violations of law.

VIDEO DEVICE CONSULTATION

James Maida, President of Gaming Laboratories International, Inc., Toms River, New Jersey, is regarded as the nation's leading expert on video lottery devices. He was consulted extensively regarding security features in the course of this review. Substantial information was obtained. The following provides only the highlights of his recommendations.

- Mr. Maida said in order to ensure the safety of those individuals playing the video lottery game, all terminals should be UL approved. He suggested an audible sound be heard when the exterior door of the video lottery terminal is opened.
- He also recommended bill acceptors in lieu of coin operated machines because of their ability to detect non-currency is superior to coin acceptors. Coin acceptors have settings on them in which the sensitivity of rejection can be minimized to the point they would accept any round object. Bill acceptors are not capable of being adjusted to that degree.
- Mr. Maida advised that a test to determine if liquids could enter the machine would be conducted by his laboratory to include: high-proof alcohol, grain alcohol and beer.
- He recommended the use of bar codes as a method to validate winning tickets. With an on-line system, this would heighten security, and virtually would ensure that no ticket is copied and claimed twice. Bar codes would satisfy the proposed specifications which require retailers to have the ability to validate winning tickets. Bar codes also could be used for machine identification, and unlike a metal plate, bar codes cannot be removed, transferred, or otherwise tampered with without detection.
- Gray machines were discussed extensively with Mr. Maida, including methods of distinguishing them from Lottery machines. He suggested the Lottery logo appear on the video screen of each device via the software. The central system could control and change the 250 lines of color in the logo, thus preventing its duplication by another source.

- Mr. Maida suggested that even though the costs are greater, the system should be on-line and use dedicated lines for the highest security possible.
- Dedicated lines, coupled with data encryption during transmission, would provide another significant layer of security protection for the central system.
- Mr. Maida advised a further measure of security is to run an in-house Central Site system. This would involve purchasing the system and possibly hiring the vendor as a consultant to perform upgrades and train Lottery personnel. He advised this currently is occurring at existing video lotteries, with the exception of West Virginia, where Scientific Games manages the day-to-day operations.
- Mr. Maida explained that should the Lottery choose to have the vendor operate the system, it would be necessary for the Lottery to closely monitor daily operations with particular attention to electronic funds transfers. By not operating its own central site, the Lottery could be subject to shut down in the event the vendor becomes entangled in a lawsuit, restraining order, bankruptcy or receivership.
- Mr. Maida suggested any operator participation should include a yearly review, including examination of income tax returns and other financial information. He advised that the most important item to know is that operators cannot cheat in enrolled games properly monitored by the central system. However, they can cheat the entire system by retaining illegal games having look-alike devices at retail locations and by skimming money from the retailer.
- Based upon start-up with 4,000 machines, Mr. Maida recommended the Oregon Lottery hire at least 10 inspectors for the start-up period to coordinate field activities. One or two personnel would be needed to complete final communications testing and interface through the various manufacturers. Additional security, audit and accountant personnel also would be needed.

Mr. Maida said if Oregon procures an on-line system with a five-second delay using dedicated line and an on-site ticket validation, either manual or bar code, it would far surpass any other system in the industry.

THE CANADIAN EXPERIENCE/ADVICE

Oregon State Police officially conducted an on-site visit in Canada. This system was selected, not just because it is one of the handful of existing video lottery operations, but because it operates a system both with operators and without operators.

The Atlantic Lottery Corporation, local law enforcement and coin operators were contacted in the provinces of New Brunswick and Nova Scotia, Canada.

The video poker system began for the Atlantic Lottery on December 1, 1990. In the New Brunswick Province age-controlled establishments, a maximum of five terminals are allowed. No more than two terminals in non-age controlled locations -- such as bowling alleys, restaurants, convenience stores and newsstands -- are permitted. In New Brunswick, net revenue is divided in the following manner: Lottery 30 percent, retailers 35 percent and operators 35 percent.

In the Province of Nova Scotia, the maximum number of machines in establishments is five. Here, however, the revenues are split only between the Lottery (65 percent) and the retailer (35 percent).

A major concern of the Atlantic Lottery is continued use of gray machines despite their ban from all the Provinces. Local police have not enforced the ban because it is a low priority. This has resulted in widespread use of these machines, not only in establishments where alcohol is served, but in convenience stores, bowling alleys, and other locations accessible to all members of the general public. This soft approach to removing gray machines not only results in competition between the two systems, but has securely implanted the gray machines so that eradication is nearly impossible.

Lottery officials stressed on several occasions that to operate a successful video lottery with or without operators, the gray machines must be eliminated prior to the lottery machines coming on line. The sales associates from the Atlantic Lottery advised that business owners often prefer the gray machines over the Atlantic Lottery machines because the business owner can negotiate a higher revenue return from the operator, and the Province is not considered in the split of revenue.

The Atlantic Lottery requires that any video lottery manufacturer sell only to approved operators. In New Brunswick, no operator may control more than five percent of the total video lottery machines in the Province. This prevents a small number of operators from monopolizing the industry and lowers the risk of abuses due to criminal activity.

The Atlantic Lottery advised it has been difficult to keep operators away that have been involved with unlawful gambling prior to the inception of the video lottery law. In New Brunswick, they had eliminated only four companies because of illegal gambling activities, and currently have one company under investigation pending the issuance of a license.

During the planning stages of video lottery in the Atlantic Provinces, coin operators attempted to convince the lottery that an advantage of operator involvement was their expertise in service, marketing and their ability to assist police with gray-machine control. Atlantic Lottery officials found to the contrary; operators did not assist in marketing the game, and according to Lottery officials, "service expertise" was limited to splitting the profits with retailers. Operators have yet to assist the police with the elimination of the gray machines in New Brunswick.

The Royal Canadian Mounted Police was contacted regarding any problems they experienced had with video lottery machines or gray machines. Sergeant Paul Desveaux, Gaming Specialist, Atlantic Quebec Region, stated that illegal activity revolving around video lottery games was "out of control." He said the tendency to attracting organized crime is compounded by the lack of law enforcement attention and resources directed toward this problem.

Sergeant Desveaux reported that a number of drug dealers in the area converted to running a gray machine business because it was more profitable.

In one particular case, Sergeant Desveaux discovered that a coin operator and a retailer were partners in a money laundering operation in which dirty money was being passed through the video poker machines at a retailer's establishment. Based on the New Brunswick split of revenue between the Lottery (30 percent) and operator (35 percent), if an operator and retailer were jointly laundering money, they could produce a 94 percent return on the dollar.

Sergeant Desveaux said distributors still are offering money to retailers to place that particular operator's video lottery machines in the retailer's establishment.

The RCMP stressed the importance of eliminating gray games from the Oregon market in order to have a fair and secure system for the state. They also advised against the direct involvement of coin operators in a state-sanctioned video lottery system.

OTHER STATES' EXPERIENCE/ADVICE

Ronald C. Kopicko of the Nevada Gaming Control Board was contacted regarding the security plan for the operation of video lottery in Oregon. Kopicko said that coin theft accounts for over 50 percent of the problems experienced by casinos in Nevada. Thus eliminating coins from being accepted by machines, 50 percent of the problems associated with theft can be eliminated. He further advised having a state-run system with no operators would further increase the security level.

Sergeant Loren Ross, Reno Police Department, advised the issuance of a "work card" as a way to maintain accurate information and control anyone who handles alcohol and money. In order to obtain a work card, the applicant must be fingerprinted and have a background check completed. In Reno, the chief of police makes the final decision as to whether an individual is approved for a work card.

Information was obtained from the Montana Department of Justice and the Great Falls Tribune regarding Zollie Kelman, who was a manufacturer of gaming devices. Kelman had been a leading figure in gambling for many years. His business ventures include manufacture, distribution and operation of video and other gambling machines and gray machines. He also was the major stockholder and CEO of a large printer of pull-tab tickets, punch boards and instant scratch tickets. He originally was charged in Montana during 1988 with numerous felony and misdemeanor counts involving allegations of forgery of gaming machines and certification stamps, possession of illegal gambling machines and distribution of illegal gambling machines.

Bend Police Department advised Kelman was alleged to have threatened a witness in the Montana prosecution who was residing in Bend, Oregon, during 1988. The case was dismissed because of lack of evidence; however, it was determined this individual did visit Bend, Oregon, and did contact the potential witness against him from Montana. Kelman was charged with seven felonies and 22 misdemeanors relating to violation of Montana's gaming laws. As a result of plea negotiations with the Cascade County Attorney's Office, Kelman plead guilty to five of the misdemeanor charges. (See Attachment B: Great Falls Tribune newspaper articles.)

OREGON EXPERIENCE

The Oregon Department of Justice provided information concerning video gambling and criminal activity that had occurred within Oregon. They supplied information that may link Oregon's illicit video gambling industry to traditional organized crime in New Jersey.

The Department of Justice provided the following case investigation information involving coin operators in Oregon. In addition to operating illegal gambling devices, evidence developed involves operator loans to retailers, money laundering, coercion, skimming and hidden ownership in OLCC-controlled establishments.

In Marion and Polk Counties, a coin operator has been the subject of two investigations that developed significant evidence linking the operator to making loans to retailers, coercion, skimming and hidden ownerships in OLCC-controlled establishments.

A coin operator in Jackson County, convicted of illegal gambling, was found to have been making loans to OLCC-controlled establishments without the OLCC being notified of these loans.

An investigation in Clackamas and Multnomah Counties revealed that a coin operator was involved in significant skimming from the illegal video machines.

In Umatilla County, two coin operators were in competition for video gambling business. Evidence was developed linking both operators to loaning money to tavern owners, skimming and threats of violence. There was also evidence of the trafficking of gray machines between Oregon and the Territory of Guam.

An investigation involving Marion and Linn Counties revealed that a husband and wife owned and operated taverns, as well as their video gambling machine business. There was evidence that some of the gamblers in their establishment were allowed to pay by personal check. This practice was evolving and extremely close to providing personal loans on the spot to gamblers.

Another Marion County case involved a husband and wife who were convicted of operating gray machines in four taverns. During the investigation, there was significant evidence of hidden ownership in several aspects of the couple's operation.

An investigation in Clackamas County in 1988 focused on five establishments. Each establishment was in serious competition with the others. Video gambling devices were only a part of these operations. There also were illegal poker and black jack games available. Skimming was prevalent and cheating in some of the games was suspected. There were serious hidden ownership concerns as well, and law enforcement concerns of infiltration by out-of-state organized crime groups.

In Union and Baker Counties, an investigation revealed that a coin operator was making more than \$5,000 per week on the operator's illegal video gambling devices. This particular operator had been convicted twice in the past of gambling offenses. During the investigation, evidence was developed of tying agreements, and one tavern owner reported pool tables and cigarette machines were removed from his establishment when he purchased his own video gambling machine.

Regarding traditional organized crime's role in Oregon, the Department of Justice advised the following:

Twelve video machines produced by Grayhound Electronics, Inc., have been seized in this state. Grayhound Electronics Inc., located in Toms River, New Jersey, has been linked to the Bruno/Scarfo organized crime family. Grayhound and its principals are the subject of criminal and civil proceedings in New Jersey. Five of these 12 Grayhound machines were seized this year from an operator who currently is under indictment for criminal racketeering. A search warrant in this case produced materials representing Grayhound Electronics and evidence of contacts between this distributor and Grayhound Electronics in New Jersey.

Grayhound Electronics currently is being sued by the State of New Jersey. The lawsuit alleges that Grayhound regularly paid money called "tribute" to Nicodemo Scarfo, Sr., who is the boss of the Scarfo crime family, a recognized group in La Cosa Nostra. The "tributes" involved would permit Grayhound to manufacture, distribute and derive revenues from gambling devices. The "tribute" also was to protect Grayhound from competition or interference from other organized criminal groups. In addition, the "tribute" was to compensate the hierarchy of the Bruno/Scarfo group for utilizing its contacts with other organized criminal groups in various other parts of the country.

Concerning possible abuses of a legal video gaming system, the Department of Justice provided the following information:

In the past, skimming has been a common problem. In a legal gaming system, however, this problem risks expansion and variation into money laundering. Money laundering presently is occurring, and it is expected to increase in the future, particularly with narcotic traffickers, because they are burdened with large amounts of cash from illicit drug sales. Narcotic traffickers will seek to launder illicit cash through legitimate businesses, preferably businesses dealing in large amounts of cash in the first place. In these businesses, the illicit cash becomes legitimate income, which may be used freely. In essence, the money launderer over reports income from the legitimate business and pays taxes on it.

The following example was supplied by the Department of Justice: A narcotics trafficker obtains ownership of the company supplying and maintaining video gambling machines. He or she therefore will legitimately profit from gambling activity involving this entity's machines. The trafficker next hires a series of "shills" and regularly supplies these individuals with large amounts of cash with which to gamble.

The shills are directed to lose the cash provided to them by gambling in specific establishments containing machines belonging to the video gambling machine company. Thereby, some of the cash loss becomes legitimate income to the drug trafficker through his interest in the company operating the video machines. The shills' winnings simply remain illicit income to launder. Experts advise that money launderers, regardless of which money laundering process they use, expect to incur losses of 50 percent or more during the laundering process.

The Department of Justice also is concerned about past practices of fierce competition among coin operators. They advise that video gambling machine operators and suppliers traditionally seek as many outlets as possible in which to place their machines. Normally competition takes place, but some of these operators regularly have sought unusual leverage over the retail outlet to encourage them to do business with the operator. Investigators found evidence of loans from operators to retailers at below-market terms. The loans sometimes led to hidden ownership. The purchase of the retailer's lease provides a great deal of leverage. In the past, there have been reports of threats of violence, coupled with sales pitches.

"Tying" agreements have been common in the past. These agreements allow the operator to place all vending and gambling machines in an establishment, or the retailer receives none. This could prove particularly distasteful when a retailer has only traditional vending machines in the establishment. Some operators have competed by negotiating the retention rate of the machine. The higher the rate, the higher the percentage of the gross receipts in the machine that is retained to be split between the operator and the retailer. In some instances, this rate has exceeded 50 percent.

Loans to gamblers themselves while they are playing the machines is a direct predicate to loan sharking. The Department of Justice has received several reports of loans to gamblers over the last ten years. This is an area of extreme concern to Lottery Security.

Organized criminals always have had an affinity for gambling of any sort and/or liquor establishments. Law enforcement must continue to be alert to hidden ownership issues and money laundering.

Finally, the Department of Justice submitted a "simulation" of applications for retail and operator contracts. The simulation demonstrates that investigating violations of the rules governing the proposed system will be as difficult and expensive as investigations of gray games have been.

RECOMMENDATIONS

To maintain the highest degree of security within the proposed video lottery system, the following is recommended:

1. The ban on gray machines be strictly enforced.
2. If the Lottery chooses to run a video lottery system, private operators should not be permitted. The Lottery itself should operate the Central Site and the field operations.
3. If operators are allowed to participate in the video lottery system, no one that has been involved in any gambling offense, any felony or any crime involving theft or deception should be allowed to participate in the video lottery endeavor.

Attached to this narrative are joint recommendations on proposed administrative rules and proposed operating plans. In it, we make suggestions for strengthening the proposals consistent with the Governor's direction to operate the most secure lottery system in the nation.

It is felt that these suggestions will help ensure that the Oregon Lottery, if they choose to operate a video lottery system, will have as safe and secure system as possible with the current technology available to this type of gambling.

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