
EVALUATION REPORT

Gambling Regulation and Oversight



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Program Evaluation Division

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OFFICE OF THE LEGISLATIVE AUDITOR

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Legislative Audit Commission

Minnesota has a large and diverse legal gambling industry. In April 2004, the Legislative Audit Commission directed the Office of the Legislative Auditor to evaluate whether the state's oversight of the industry is sufficient and whether the state's approach—with oversight authority divided among four state agencies—makes sense.

We found strengths in Minnesota's regulation of gambling, but also significant weaknesses. For example, state oversight of horse racing and lottery games is thorough and multi-layered. However, the state does not adequately detect and deter noncompliant charitable gambling activities or oversee the card club at Canterbury Park. In addition, the state could more effectively use its authority to inspect Indian casinos. Overall, the weaknesses we identified can be addressed without consolidating the state's gambling regulatory agencies. We recommend corrective actions to each agency and suggest that they better coordinate their efforts.

This report was researched and written by Deborah Parker Junod (project manager), Carrie Meyerhoff, and Judy Randall. The Gambling Control Board, Minnesota Racing Commission, Minnesota State Lottery, and Department of Public Safety Alcohol and Gambling Enforcement Division cooperated fully with our review. In addition, four of the state's Indian tribes provided valuable assistance.

Sincerely,

/s/ James Nobles

James Nobles
Legislative Auditor

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Summary

Some types of gambling need stronger state oversight.

Major Findings:

- We found strengths and significant weaknesses in Minnesota's regulation and oversight of gambling.
- The Gambling Control Board does not adequately detect and deter noncompliant activities by organizations involved in charitable gambling. Some organizations have excessive expenses and make small contributions to charities (pp. 21-39).
- The Minnesota Racing Commission provides thorough and multi-layered oversight of horse racing but does not adequately oversee the card club at Canterbury Park (pp. 50-56).
- The Lottery protects the integrity of its scratch and online games with a comprehensive set of security procedures (pp. 66-74).
- The Alcohol and Gambling Enforcement Division does not effectively use its authority to inspect Indian casinos. However, regulation by tribes and the federal government mitigate limitations in state oversight authority and inspection practices (pp. 80-89).
- Some agencies involved in gambling regulation do not have sufficient staff expertise and do not use technology effectively (p. 104).

- Improvements in Minnesota's regulation of gambling are possible without a reorganization of the agencies involved. Specifically, we do not think consolidating the agencies would be useful (p. 105).

Key Recommendations:

- The Gambling Control Board should more effectively use its authority and resources to detect and deter noncompliance, and the Legislature should reconsider the scope and focus of the Gambling Control Board's responsibilities in regulating charitable gambling (pp. 41-45).
- The Racing Commission should expand card club oversight and increase staff expertise in this area (p. 61).
- The Alcohol and Gambling Enforcement Division should fully utilize its casino inspection authority and change how it assigns staff to casino oversight (pp. 98, 100).
- All of Minnesota's gambling regulatory agencies, except the Lottery, should make better use of technology to fulfill their oversight and regulatory responsibilities (pp. 43, 62, 98).

The Gambling Control Board has reduced its charitable gambling compliance presence.

Report Summary

Gambling is a multi-billion dollar industry in Minnesota, regulated by four state agencies. The Gambling Control Board regulates pull-tabs, bingo, and other forms of charitable gambling; the Racing Commission regulates horseracing and a card club at Canterbury Park; the Minnesota State Lottery regulates—and promotes—lottery games; and the Alcohol and Gambling Enforcement Division (AGED) in the Department of Public Safety oversees certain aspects of Indian casino gaming.

We evaluated each agency’s regulatory activities, including how each one ensures the integrity of games and the proper distribution of proceeds. We also assessed whether Minnesota’s segmented approach to gambling oversight is an effective and efficient organizational structure.

The Gambling Control Board Does Not Adequately Detect and Deter Charitable Gambling Noncompliance

As a complex, cash-based industry, charitable gambling is vulnerable to abuse, including cheating, theft, and misuse of proceeds. Over 1,400 licensed nonprofit organizations run charitable gambling operations at approximately 3,000 sites, using over 20,000 employees and an unknown number of volunteers. The board uses standard techniques, such as licensing, education, and compliance reviews to enforce laws regulating game play and the use of proceeds.

We found shortcomings in each area, and taken together, the board’s regulatory efforts do not adequately detect and deter noncompliant activities by organizations involved in charitable gambling. For example, the board does not verify that all licensing

requirements regarding criminal history are met, and the board has not been able to provide the amount of training it believes is necessary. In addition, the Gambling Control Board does not conduct enough compliance reviews and site inspections. The board reviews each licensed organization’s operations on a rotating basis, and its goal is to review each organization every two years. In calendar year 2003, board staff were on pace to conduct compliance reviews of each organization every 2.7 years. The board has also cut back on the number of on-site inspections it does. According to the board, recent budget and staff cuts have reduced its compliance presence statewide.

To more effectively adjust to budget cuts, the board needs to change how it uses some of its resources. Specifically, the board needs to invest in technology, systematically analyze data to better understand compliance problems and trends, and target site visits and compliance reviews on organizations that show signs of problems. We also think the Legislature should critically reassess the scope and focus of the board’s regulatory responsibilities. For example, the Legislature may want to shift regulatory responsibility for permitting small gambling events from the state to local governments or eliminate it altogether. The Legislature may also want to change how the state regulates the use of charitable gambling proceeds by focusing more on the proportion of proceeds going to charity and less on the proportion used for gambling business expenses.

Some Organizations Involved in Charitable Gambling Have Excessive Expenses

State law limits how much charitable gambling organizations can spend on total gambling business expenses, such

The Legislature should consider new approaches to regulating the use of charitable gambling proceeds.

In overseeing the card club, the Racing Commission relies too heavily on self-regulation by Canterbury Park.

as rent and salaries. For most types of charitable gambling, organizations can spend up to 55 percent of gross profit (gross receipts less prizes) on business expenses. However, compliance with the law is measured in such a way that organizations can spend more on business expenses on an annual basis than the limit suggests is appropriate. Fiscal year 2003 tax data showed that, measured on an annual basis, 592 organizations (43 percent) exceeded the business expense limits established in statute. We estimated that the 127 organizations that exceeded the spending limit by over 25 percent spent, on average, four to five times the amount to raise a dollar for lawful purposes than organizations that spent within the limit. The amount of money consumed by gambling business expenses is important because it affects the amount of money available for charities.

The Racing Commission's Oversight of the Canterbury Park Card Club Is Inadequate

While the Racing Commission provides effective oversight of horse racing, the commission relies too heavily on Canterbury Park for oversight of card club activities. The Racing Commission employs stewards, veterinarians, and barn technicians to oversee racing. Each of these personnel has a specific role in ensuring the integrity of horse racing. In contrast, the Racing Commission does not have personnel with sufficient expertise to oversee card club activities, and the commission relies too much on self-regulation by Canterbury Park.

Racing Commission staff rely on Canterbury Park employees to notify them of problems that arise in the card club, but the commission may not be aware of all relevant surveillance observations. During fiscal year 2004,

Canterbury Park personnel observed 28 incidents, such as cheating and theft, that should have been reported to the Racing Commission, but commission staff remember being informed of only 23 of them. In addition, the commission does not regularly verify compliance with the card club plan of operations or review and approve expenditures from a special card club fund over which the commission has specific authority.

The Lottery Adequately Ensures the Integrity of Its Games

The Lottery is both the promoter and regulator of the games it offers, a situation that could compromise game integrity. However, the Lottery does an adequate job protecting the security of both its scratch and online games and ensuring that Lottery proceeds are allocated properly. While no system is foolproof, the Lottery has comprehensive procedures that minimize the risk of cheating. It verifies the physical security of scratch game tickets, protects against ticket tampering, and ensures secure electronic ticket validation. Finally, the Lottery investigates any suspicious activity regarding game play to make certain that only fairly purchased and valid tickets are redeemed. As the Lottery's use of technology has improved, the number of these investigations has decreased.

The Lottery also adequately ensures that its proceeds are allocated appropriately. In general, the Lottery holds retailers responsible for selling and properly redeeming tickets. Because the Lottery is a state agency, distribution of its proceeds to different state funds is done through the state's accounting system. The Lottery works with the departments of Finance, Revenue, Natural Resources, and Human Services to ensure that revenues are properly allocated.

The Lottery has comprehensive procedures that reduce the risks to its games.

The Alcohol and Gambling Enforcement Division should make better use of available information when inspecting Indian casinos.

We did not find a compelling case to consolidate the state's gambling regulatory agencies.

The Alcohol and Gambling Enforcement Division Does Not Effectively Use Its Authority to Inspect Casinos

Minnesota's 11 Indian tribes operate 18 casinos located around the state. Tribes have primary responsibility for ensuring that these casinos operate with integrity, and the state has secondary oversight authority. Legal agreements between the state and each tribe, called "compacts," establish rules for blackjack and slot machine gambling and grant casino inspection rights to the Minnesota Department of Public Safety's Alcohol and Gambling Enforcement Division (AGED) for the purposes of verifying compact compliance.

The division's casino inspections are the primary means through which the state can directly assess compliance with slot machine and blackjack compacts, but AGED does not make full use of its inspection authority. Specifically, the division has focused its oversight on physical inspections of selected slot machines in a casino. Under the compacts, AGED has access to an array of information, including relevant casino information systems, casino financial and internal control audits, compliance data from tribal regulatory authorities, and AGED's own observations. With a few exceptions, AGED has not fully used these sources, so its judgments regarding compact compliance are based on limited information. In addition, AGED's policy of assigning sworn law enforcement officers to tribal gaming matters on a part-time basis has hindered casino oversight.

Segmenting Gambling Regulation Among State Agencies Is Reasonable Given the Specialized Oversight Requirements of the Different Types of Gambling in Minnesota

Minnesota's gambling laws and regulatory approach have evolved as the scale and nature of legal gambling have changed, resulting in a segmented and specialized oversight structure. We identified a number of common problems among three of the four regulatory agencies we evaluated (the Lottery being the exception). The problems include inadequate use of technology and strategic analysis and gaps in staff expertise. However, we did not find a compelling case for consolidating the agencies. Many of the deficiencies we identified did not appear to result from the state's segmented approach to gambling oversight, nor would solutions necessarily result from consolidation.

Still, strengthening Minnesota's regulation of gambling will require a cooperative, multi-agency response. For example, to effectively target its criminal investigation resources, AGED needs to work with the other agencies to define compliance priorities and use these priorities to guide which cases should be referred to the division and when. In addition, there may be opportunities for the Gambling Control Board and Racing Commission to share technology support and for the board to improve its information exchange with the Department of Revenue.

Introduction

In Minnesota, state government oversight of legal gambling is divided among four agencies.

Legal gambling is a diverse, multi-billion dollar industry in Minnesota. Minnesotans and visitors can play pull-tabs and bingo, bet on live horse races, play poker, buy Lottery tickets, or visit casinos to play slot machines. As it is nationally, gambling is a regulated industry in Minnesota, and the state has divided oversight authority primarily among four agencies—the Gambling Control Board, the Minnesota Racing Commission, the Minnesota State Lottery, and the Department of Public Safety. Although their roles and responsibilities vary, these agencies share common goals, including minimizing the risk of cheating, theft, and other noncompliance with state law and ensuring that gambling proceeds are distributed according to applicable laws. In the end, state oversight should help reassure the public that Minnesota’s gambling industries operate with integrity.

In April 2004, the Legislative Audit Commission directed us to evaluate the state’s regulation and oversight of legalized gambling. Legislators’ questions centered on whether state oversight is sufficient and whether the state’s approach—with oversight responsibility divided among several agencies—makes sense. In addition to providing information on Minnesota’s gambling industry and regulatory structure, our evaluation addressed the following questions:

- **To what extent does state regulation and oversight help ensure the integrity of legal gambling in Minnesota?**
- **To what extent does Minnesota’s regulatory structure ensure that gambling oversight meets the state’s regulatory goals efficiently and effectively?**

To answer these questions, we interviewed staff from the four agencies with gambling oversight responsibility (the Gambling Control Board, Racing Commission, Lottery, and Department of Public Safety), as well as counsel from the Attorney General’s Office. We also reviewed Minnesota statutes and rules, examined agency procedures, and analyzed data provided by each agency.

We did additional work at each of the four agencies. To assess the Gambling Control Board’s effectiveness, we analyzed charitable gambling organizations’ tax data obtained from the Department of Revenue and board data on compliance reviews, citations, charitable contributions, and game testing; observed compliance inspections; and met with officials from groups representing nonprofit organizations that conduct charitable gambling and charitable organizations that benefit from the proceeds. At the Minnesota Racing Commission, we analyzed financial and surveillance data collected by the racetrack, met with racetrack personnel, and observed commission practices such as veterinarian pre-race exams and stewards’ appeal hearings. To understand how the Minnesota State Lottery protects its games, we reviewed game documentation for 20 of 40 scratch

games introduced in fiscal year 2003 and observed Powerball and Daily 3 drawings.

To assess the state's oversight of casinos, we analyzed Department of Public Safety casino inspection records, observed a casino slot machine inspection, and met with officials from the National Indian Gaming Commission. We also visited five Indian casinos, where we interviewed tribal leaders, casino managers, and casino regulators.¹ To evaluate the Department of Public Safety's background and criminal investigation activities, we analyzed data on investigations conducted in fiscal years 2000 through 2004 and interviewed officials from the other regulatory agencies about investigation quality and timeliness.

We focused our work on legal forms of gambling and the state's efforts to regulate and oversee these activities. As such, we did not review illegal gambling, such as sports bookmaking and Internet gambling, nor did we assess gambling tax compliance. Similarly, we did not review the social costs of gambling or gambling addiction. Because we concentrated our work on state agencies' efforts to regulate gambling, we did not review gambling-related regulation or law enforcement at the federal or local levels.

This report is divided into six chapters. In Chapter 1, we provide an overview of the gambling industry in Minnesota, including the types of gambling allowed and the different state agencies with oversight responsibility. In Chapter 2, we discuss how the Gambling Control Board oversees charitable gambling, such as pull-tabs and bingo. In Chapter 3, we detail the role the Racing Commission plays in regulating horse racing and the card room at Canterbury Park, while in Chapter 4, we discuss how the Lottery protects the integrity of its games. In Chapter 5, we discuss how well the Department of Public Safety's Alcohol and Gambling Enforcement Division inspects Indian casinos and uses its investigation resources. In Chapter 6, we assess whether the state's segmented regulatory structure is reasonable and discuss concerns that cross agencies.

¹ Because they are sovereign nations, our office does not have jurisdiction over Minnesota's Indian tribes. However, four tribes volunteered to participate in our evaluation—the Bois Forte Band of Chippewa, Mille Lacs Band of Ojibwe, Prairie Island Indian Community, and Upper Sioux Community. We visited both of the casinos operated by the Mille Lacs Band of Ojibwe.

Background

SUMMARY

Minnesotans and visitors wager billions of dollars a year on the state's various forms of legal gambling. These include pull-tabs, bingo, and other forms of charitable gambling; horseracing and card games at Canterbury Park; lottery games; and slot machines and blackjack at Indian casinos. Four state agencies regulate gambling: the Gambling Control Board, Minnesota Racing Commission, Minnesota State Lottery, and Alcohol and Gambling Enforcement Division in the Department of Public Safety. Although their responsibilities and authority vary, each agency seeks to ensure the integrity of gambling by preventing cheating and theft and to ensure that gambling proceeds are distributed according to state law. The agencies use similar regulatory techniques to oversee the different types of gambling, including licensing, education, compliance checks, and investigations.

Gambling is a multi-billion dollar industry in Minnesota. It includes various forms of gambling allowed for nonprofit fund-raising purposes, such as pull-tabs and bingo; horse racing and card games; a state operated lottery; and casino slot machines and blackjack. As in other states, gambling is a regulated industry in Minnesota, controlled by laws, rules, and regulatory agencies. State regulation of gambling is divided primarily among four agencies, but other federal, tribal, state, and local authorities also play a role.

The purpose of our evaluation was to assess how effectively the state's gambling regulatory agencies implement their respective roles in ensuring gambling integrity and whether the current multi-agency approach allows the state to regulate gambling in the most effective and efficient ways possible. As background, this chapter addresses the following questions:

- **What types of gambling are legal in Minnesota, and how profitable is each?**
- **How does Minnesota regulate legalized gambling?**

To answer these questions, we reviewed state laws, legislative reports, and various documents that discuss the history and current structure of gambling regulation in Minnesota. In addition, we analyzed available data on gambling profits and regulatory agency staffing and budgets. Finally, we interviewed state and federal regulators about the laws, rules, and procedures that define the state's regulatory approach and the relationship between state, federal, tribal, and local authority.

TYPES OF LEGAL GAMBLING

Legal gambling is a multi-billion dollar industry in Minnesota.

People in Minnesota can gamble in several different venues and for a variety of purposes. State law allows for unregulated social gambling, such as poker games held in private homes. In addition, the state allows and regulates various types of commercial gambling, which for the purposes of our evaluation, we grouped into four categories:

- Pull-tabs, bingo, raffles, paddlewheels, and tipboards operated by nonprofit organizations for the purpose of fundraising (called charitable or lawful gambling);
- Horse racing and racetrack card clubs, currently limited to Canterbury Park;
- A state lottery; and
- Slot machines and blackjack at Indian casinos.

After paying out gamblers' winnings, the gambling industry generates over \$1 billion a year in gross profit for the various organizations that run gambling operations in the state. As shown in Table 1.1, casino gambling and nonprofit fundraising through charitable gambling are the largest money-makers, followed by lottery and horse racing and card club activities.

Table 1.1: Estimated Annual Gross Profits, After Prizes, From Legal Gambling in Minnesota

	Estimated Gross Profit After Prizes Paid to Winners (in Millions)
Casino Slot Machines and Blackjack	\$900 – 1,400 ^a
Charitable Gambling	257 ^b
Lottery	161
Horse Racing and Card Club	39
Total	\$1,357 – 1,857

^aIndian tribes are not obligated to make information on casino revenues public. The range shown is from published casino industry estimates.

^bAmount reflects charitable gambling activity of licensed nonprofit organizations only.

SOURCES: Jason A. Ader and Marc J. Falcone, *Bear Stearns North American Gaming Almanac, 2001-2002* (Las Vegas, NV: Huntington Press, 2001), 321; Alan Meister, *Indian Gaming Industry Report* (Newton, MA: Casino City Press and Analysis Group, Inc., 2004), 9; Office of the Legislative Auditor analysis of Department of Revenue charitable gambling tax data; Minnesota State Lottery, *2004 Annual Report* (Roseville, MN, 2004); Minnesota Racing Commission, *Minnesota Racing Commission 2003 Annual Report* (Shakopee, MN, 2004); and Canterbury Park Holding Corporation, *2003 Annual Report* (Shakopee, MN, 2004).

STATE REGULATORY AGENCIES

As shown in Table 1.2, state government oversight of legal gambling is divided primarily among four organizations: the Gambling Control Board, the Minnesota Racing Commission, the Minnesota State Lottery, and the Alcohol and Gambling Enforcement Division of the Minnesota Department of Public Safety. The agencies' responsibilities and authority vary, but they perform similar regulatory activities, including licensing, rulemaking, training, compliance reviews, and enforcement.

Table 1.2: Minnesota Gambling Regulatory Agencies

In Minnesota, state government oversight of gambling is divided among four agencies.

Gambling Control Board	<ul style="list-style-type: none"> • Regulates charitable gambling.^a • A citizen board of 7 members and a regulatory office with an executive director and a staff of about 30.
Minnesota Racing Commission	<ul style="list-style-type: none"> • Regulates horse racing and racetrack card clubs. • A citizen board of 9 members and a regulatory office with an executive director and a staff of about 6.
Minnesota State Lottery	<ul style="list-style-type: none"> • An independent agency responsible for the production, promotion, and integrity of lottery games. • The Lottery's security department, with a staff of about 7, has primary responsibility for game integrity. However, security provisions are embedded throughout the Lottery's operations.
Alcohol and Gambling Enforcement Division	<ul style="list-style-type: none"> • Oversees slot machine and blackjack gambling at Indian casinos. • A division within the Minnesota Department of Public Safety that, in addition to overseeing certain aspects of casino gambling, conducts gambling-related background and criminal investigations. It has a director and a gambling enforcement staff of about 12.

^aCharitable gambling includes pull-tab, bingo, raffle, paddlewheel, and tipboard games operated by nonprofit organizations for the purpose of charitable fundraising.

SOURCE: Office of the Legislative Auditor.

Other entities are involved to various degrees in gambling oversight and regulation. For example, cities and counties can levy gambling-related taxes, require charitable gambling permits for some unlicensed organizations, and issue regulations more stringent than state law. The Minnesota Department of Revenue administers state taxes on gambling. Local law enforcement may be involved in gambling investigations and enforcement. Tribal governments are primary regulators of casino gambling, and several federal agencies are involved in casino oversight as well.

Gambling Control Board

The Gambling Control Board regulates charitable gambling (also called “lawful gambling”). The board’s purposes include taking all necessary steps to ensure the integrity of and public confidence in charitable gambling and ensuring compliance with all applicable laws and rules.¹ The board’s many regulatory activities directed to achieving these purposes include: (1) licensing nonprofit organizations and their gambling managers, issuing permits to licensed organizations for each gambling site they operate, and registering licensed organizations’ paid gambling employees; (2) licensing gambling equipment manufacturers, distributors, distributor salespeople, and bingo hall operators; (3) issuing permits to unlicensed organizations that conduct small and infrequent charitable gambling activities; (4) providing education and mentoring; (5) conducting compliance reviews, site inspections, and investigations; (6) reviewing and testing gambling equipment; and (7) issuing penalties to noncompliant licensees. The Gambling Control Board’s fiscal year 2004 budget, which is provided by dedicated funds generated by fees charged to licensees, was about \$2.5 million.

Veterans, fraternal, religious, and other nonprofit organizations may conduct charitable gambling. These nonprofit organizations may choose to offer various types of games, as shown in Table 1.3, but in Minnesota, pull-tabs are by far the

Table 1.3: Types of Charitable Gambling

		FY 2004 Gross Profit ^a
Pull-tab	A folded or banded ticket with perforated break-open tabs, the face of which is initially covered to conceal one or more numbers or symbols, where one or more of each set of tickets or cards has been designated in advance as a winner.	\$233,527,000
Bingo	A game in which a caller selects balls printed with combinations of letters and numbers corresponding to combinations on bingo cards or sheets. Players purchase bingo cards or sheets and mark off the called combinations if they are on their bingo cards. The winner is the player whose marked off squares complete the winning pattern for the game.	15,690,000
Paddlewheel	A wheel marked off into sections containing one or more numbers, and which, after being turned or spun, uses a pointer or marker to indicate winning chances. The winner is the player whose ticket corresponds to the number on which the pointer lands after the paddlewheel is spun.	3,939,000
Raffle	A game in which a participant buys a ticket for a chance at a prize with the winner determined by a random drawing to take place at a location and date printed upon the ticket.	2,798,000
Tipboard	A board, placard, or other device containing a seal that conceals a winning number or symbol for the game. Players buy a ticket, the face of which is initially covered or otherwise hidden from view. The winner is the player whose ticket corresponds to the winning number or symbol for the game, which is revealed when the seal is removed.	1,326,000

^aGross profit (sometimes called net receipts) is the amount wagered less prizes.

SOURCES: *Minn. Stat.* (2004), §349.12 and Office of the Legislative Auditor analysis of Department of Revenue charitable gambling tax data.

¹ *Minn. Stat.* (2004), §349.151, subd. 4(a)(4) and (17).

The Gambling Control Board regulates charitable gambling operated by nonprofit organizations.

most popular. Pull-tab gambling generated a fiscal year 2004 gross profit of \$234 million after prizes were paid.

The extent of state regulation of charitable gambling generally depends on the form of gambling, the frequency, and the amount of money involved, as shown in Table 1.4. In fiscal year 2004, unlicensed organizations conducted over 4,400 exempt or excluded gambling activities, with exempt activities generating \$27.6 million in gross receipts.² However, the majority of charitable gambling was conducted by the over 1,450 nonprofit organizations licensed to conduct charitable gambling. As Table 1.5 shows, people wagered over \$1.4 billion on charitable gambling conducted by licensed organizations in fiscal year 2004, of which about \$1.2 billion was returned to bettors as prizes. Gross profits (after prizes were awarded) totaled \$257 million, with gross profits generated by individual licensed organizations ranging from under \$5,000 to over \$4 million. After business expenses, state taxes, and the board’s regulatory fee, licensed organizations generated and donated an estimated \$73 million for lawful purposes

Table 1.4: Categories of Charitable Gambling Activity

Excluded	<p>Small and infrequent bingo events or raffles are “excluded” charitable gambling. For example, bingo is an excluded activity if the nonprofit organization conducts four or fewer bingo occasions a calendar year. Raffles are excluded if the total value of raffle prizes awarded by the organization does not exceed \$1,500 a calendar year.</p> <p>Nonprofit organizations must obtain a permit for each excluded event. There is no permit fee.</p>
Exempt	<p>Charitable gambling activities are “exempt” if a nonprofit organization conducts the activities on five or fewer days in a calendar year and does not award more than \$50,000 in prizes for the year.</p> <p>Nonprofit organizations must obtain a permit for each exempt event. The permit fee is \$50. Organizations must file reports of gross receipts and expenditures for each event with the Gambling Control Board.</p>
Licensed	<p>Nonprofit organizations that conduct charitable gambling events more often or with higher prizes than excluded or exempt activity must get a license.</p> <p>The license period is two years and the fee is \$350 per year. Licensed organizations must file monthly charitable gambling tax returns with the Department of Revenue and reports of charitable contributions with the Gambling Control Board.</p>
Other	<p>Other legal charitable gambling includes high school raffles and small bingo events conducted in nursing homes or senior citizen housing, or by a senior citizen organization. These may be conducted without a permit or license.</p>

SOURCES: *Minn. Stat.* (2004), §§349.166, subds. 1 and 2 and 609.861, subd. 5; and Office of the Legislative Auditor.

² The Gambling Control Board does not collect data on money generated by excluded activities.

Table 1.5: Allocation of Licensed Nonprofit Organizations' Charitable Gambling Proceeds, FY 2004

	Amount (in Millions)
Gross Receipts	\$1,418
Prizes	1,161
Gross Profit (Gross receipts less prizes)	257
Business Expenses	126
State Taxes and State Regulatory Fee ^a	58
Money Available for Other "Lawful Purpose" (or Charitable) Contributions ^a (Gross profit less business expenses, state taxes, and state regulatory fee)	73

^aState taxes are an estimate based on fiscal year 2004 taxes adjusted by a calendar year 2003 tax credit of \$6.9 million. Thus, money available for other lawful purpose contributions is also an estimate.

SOURCE: Office of the Legislative Auditor analysis of Department of Revenue charitable gambling tax data.

in fiscal year 2004.³ In the end, about \$.05 of each dollar gambled—about 28 percent of gross profits—was donated to lawful purposes other than state taxes and the board's regulatory fee.

Although the Gambling Control Board issues permits to unlicensed nonprofit organizations to conduct charitable gambling activities, most of the board's resources are focused on licensed organizations. As described in Chapter 2, the regulatory challenge for the Gambling Control Board is ensuring the integrity of games conducted at over 3,000 sites operated by licensed organizations throughout the state and ensuring that the roughly 1,450 licensed gambling organizations use their net gambling profits only for lawful purposes defined in statute.

Minnesota Racing Commission

The Racing Commission's regulatory authority is currently focused on one venue, Canterbury Park, which conducts horse races and operates a card club. Canterbury Park offers live racing for approximately 17 weeks during the summer and simulcast racing (the televised display, for wagering purposes, of horse races conducted at other locations) year-round. In addition, the Canterbury Park card club is open 24 hours a day, year-round.

The Minnesota Racing Commission is responsible for ensuring the integrity of horse racing in the state. To fulfill this responsibility, the commission is expected to: (1) license all personnel working at or for the racetrack, (2) help protect the health of the horses, (3) ensure that races are conducted fairly, and (4) ensure that

³ The Legislature has defined 19 categories of lawful purposes. In addition to more traditional charitable causes, lawful purposes include federal, state, and local gambling taxes; regulatory fees; and audit fees; among other things. In Table 1.5 we present state taxes and the board's regulatory fee separately from other lawful purposes.

The Racing Commission oversees horse racing and the card club at Canterbury Park.

proceeds are properly allocated. The Racing Commission also has regulatory authority over the card club that is located at the racetrack and is responsible for ensuring that card club activities adhere to all relevant rules and procedures.

As illustrated in Table 1.6, money wagered on horse racing and card club activities is allocated to several different purposes, including prizes to bettors, purses for horse races, the state's pari-mutuel tax, and the breeders' fund, among others.⁴ Notably, the racetrack must pay the state pari-mutuel tax on live and simulcast racing once the takeout (total amount wagered less prizes to bettors) exceeds \$12 million, but is not required to pay a gambling tax on any card club revenue. About half of the Racing Commission's budget is provided by dedicated funds generated by fees charged to licensees. In fiscal year 2004, the Racing Commission received almost \$435,000 in licensing fees, of which the Legislature authorized the commission to spend \$421,000. In addition, the commission received approximately \$483,000 in fiscal year 2004 as reimbursement from the racetrack for costs associated with overseeing live racing and regulating the card club, among other things.

Table 1.6: Allocation of Horse Racing and Card Club Proceeds, 2003

	<u>Amount</u>
Racing	
Amount Wagered on Live and Simulcast Horse Racing (Handle)	\$80,520,000
Bettor Return (Prizes)	63,380,000
Takeout (Handle less prizes) ^a	16,170,000
Distribution of Takeout to State and Racing Purposes	
Allocation to Purses	\$4,680,000
Allocation to Breeders' Fund	870,000
Pari-Mutuel Tax to State	250,000
Card Club	
Amount Paid to Play (Rake) ^b	\$22,170,000
Distribution of Rake to State and Racing Purposes	
Allocation to Purses	\$2,790,000
Allocation to Breeders' Fund	310,000
Gambling Tax to State	0

^aThis calculation is not precise due to breakage—the cents not paid to winning bettors due to rounding down to the nearest 10 cents. In 2003, the breakage was about \$970,000.

^bDue to the nature of card club games, the amount returned to bettors with winning hands is unknown.

SOURCES: Minnesota Racing Commission, *Minnesota Racing Commission 2003 Annual Report* (Shakopee, MN, 2004) and Canterbury Park Holding Corporation, *2003 Annual Report* (Shakopee, MN, 2004).

⁴ The breeders' fund benefits the horse racing industry in Minnesota and encourages Minnesotans to participate in the racing and breeding industry by providing additional financial awards to Minnesota owners, trainers, and breeders.

Minnesota State Lottery

Minnesota is currently one of 42 states that authorize a lottery.⁵ Like most of these states, Minnesota has “scratch” (also called “instant”) and “online” games. Scratch games are games in which players purchase a ticket and scratch off a play area to reveal whether or not they have won a prize. Online games are games in which players purchase a ticket with a series of numbers, and the winning numbers are subsequently chosen in a daily or weekly drawing. Examples of online games are Gopher 5 and Powerball.

The Minnesota State Lottery is both the regulator and promoter of its games.

The Minnesota State Lottery is both the regulator and promoter of lottery games in the state. It is responsible for ensuring the integrity of lottery games, as well as producing, distributing, and marketing lottery games. As the regulator of lottery games, the Lottery should: (1) review criminal history records for employees and retailers, (2) ensure that scratch game tickets are tamper-resistant and online games are secure, and (3) ensure that only valid winning tickets are redeemed.⁶

In fiscal year 2004, the Lottery sold almost \$387 million in scratch and online tickets, resulting in \$226 million in prizes and a contribution of \$101 million to the State of Minnesota.⁷ As shown in Table 1.7, Lottery proceeds are divided among prizes, operating costs, retailers, and allocations to the state. In fiscal year 2004, 58 percent of the Lottery’s revenues went to player prizes, although this ranged from 50 percent of Powerball revenues to approximately 70 percent of revenues for some scratch games. In fiscal year 2004, retailers received approximately 6 percent of Lottery revenues in the form of commissions and

Table 1.7: Allocation of Lottery Proceeds, FY 2004

	Amount (in Millions)
Revenue	
Sales	\$387
Expenses	
Prizes	226
Operating Expenses ^a	38
Retailer Commissions and Incentives	23
Lottery Proceeds Allocated to the State ^b	101

NOTE: Total expenses exceed revenue due to rounding.

^aOperating expenses include salaries, benefits, and advertising costs as well as direct costs such as ticket costs.

^bLottery proceeds allocated to the state include in-lieu-of-sales tax, net proceeds from the current year, contributions to the state’s compulsive gambling fund, and unclaimed prizes from previous years.

SOURCE: Minnesota State Lottery, *Minnesota State Lottery Annual Report 2004* (Roseville, MN, 2004).

⁵ This includes the District of Columbia.

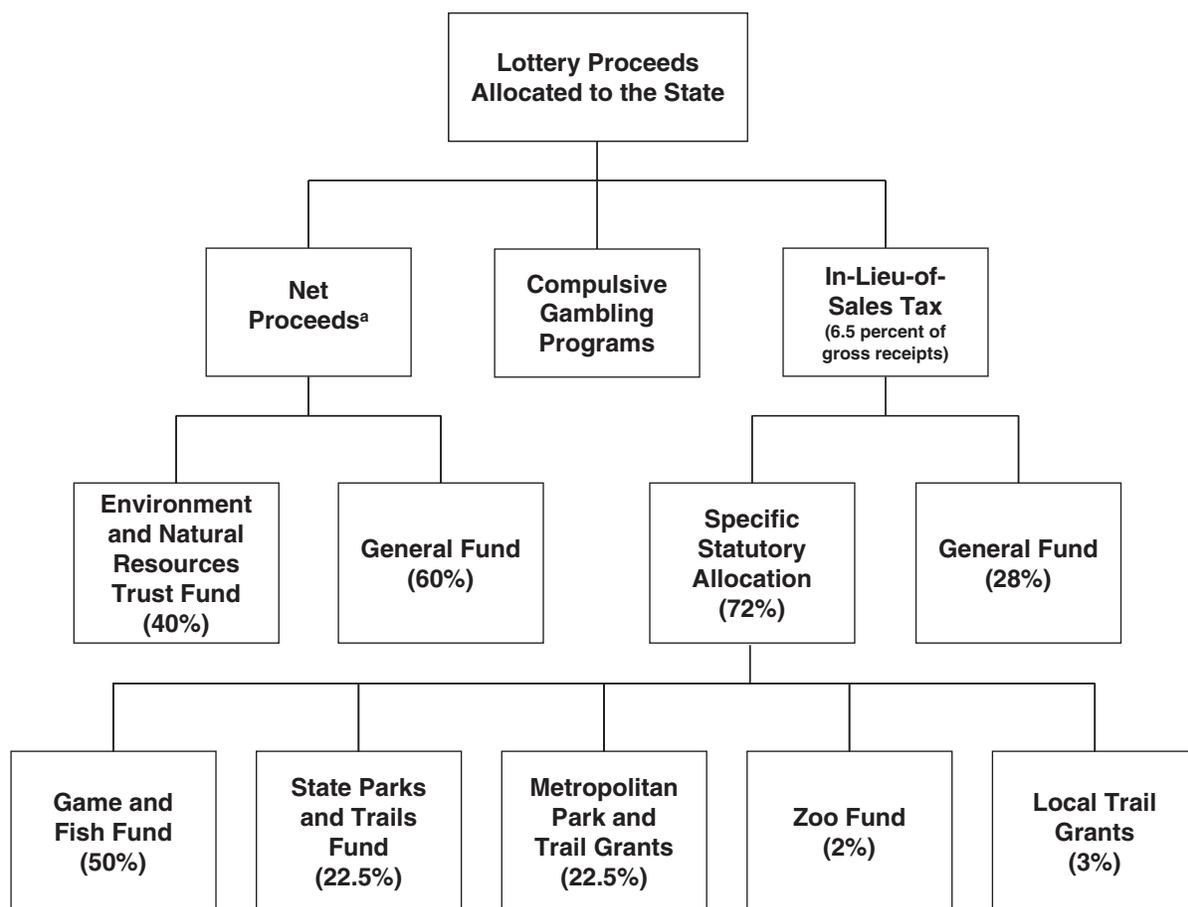
⁶ The law requires that individuals and vendors meet certain criteria in order to conduct business with the Lottery, including not having been convicted of a felony or a crime involving fraud in the last five years. Unlike the other gambling regulatory agencies in the state however, the Lottery does not license its employees or vendors.

⁷ Minnesota State Lottery, *2004 Annual Report* (Roseville, MN, 2004).

other incentives, and about 26 percent, through the in-lieu-of-sales tax, net proceeds, and other contributions, was allocated to the state.⁸ As shown in Figure 1.1, the Lottery’s financial contribution to the state is divided among several different funds—the state’s General Fund; Environment and Natural Resources Trust Fund; Game and Fish Fund; and a variety of natural resources funds for parks, zoos, and trails.

The Lottery relies on several private vendors to help protect and operate the Lottery. The Lottery uses ticket manufacturers to produce and review the scratch game tickets, and an independent auditor ensures that the proper number of winning tickets are included in each game. The Lottery also uses an independent laboratory to test the scratch game tickets and ensure that they are tamper-resistant. The Lottery relies even more heavily on GTECH, its online games vendor, for recording, reporting, and verifying online game transactions.

Figure 1.1: Allocation of Lottery Proceeds to State Funds



^aNet proceeds is the amount of revenue remaining after prizes, operating costs, retailer commissions, and in-lieu-of-sales tax are paid.

SOURCES: *Minn. Stat.* (2004), §§349A.10, 297A.65, and 297A.94(e); and *Laws of Minnesota* (1sp 2003), ch. 14, art. 13c, sec. 2, subd. 1.

⁸ Instead of a sales tax on consumers when tickets are purchased, the state collects a 6.5 percent in-lieu-of-sales tax on ticket sales directly from the Lottery.

The Alcohol and Gambling Enforcement Division has several gambling oversight roles, including casino oversight and law enforcement.

Alcohol and Gambling Enforcement Division

The Department of Public Safety's Alcohol and Gambling Enforcement Division (AGED) plays several distinct roles regarding gambling in Minnesota.⁹ The Department of Public Safety is the only state agency with oversight authority over Minnesota's Indian casinos, and it also licenses manufacturers and distributors of casino gambling devices, such as slot machines. In addition, the department (1) conducts background investigations on certain manufacturers, distributors, contractors, and individuals working in Minnesota's gambling industries and (2) investigates criminal allegations related to legal and illegal gambling.¹⁰ The division receives \$150,000 from the state's Indian tribes each year, is reimbursed by license applicants for the costs of some background investigations, and is otherwise funded from the state's general fund. The division's gambling enforcement budget in fiscal year 2004 totaled about \$1.8 million.

Indian Casino Oversight

The State of Minnesota has a limited role in overseeing Indian casinos. Under the terms of the federal Indian Gaming Regulatory Act of 1988 (IGRA), federal, state, and tribal governments share authority for regulating and overseeing tribal gaming.¹¹ As shown in Table 1.8, IGRA established three classes of tribal gaming, and regulatory roles and responsibilities vary by class. States are most involved in overseeing class III gaming. To operate a casino, IGRA requires tribes to enact tribal gaming ordinances or resolutions and to negotiate with states compacts that govern the conduct of class III casino gambling.¹²

By 1992, the State of Minnesota had negotiated compacts with each of the states' 11 tribes. These compacts allow two types of class III gaming: video games of chance (slot machines) and blackjack.¹³ As shown in Figure 1.2, tribes currently

⁹ The division is divided into two units—gambling enforcement and alcohol enforcement. Our work focused exclusively on the gambling enforcement function. Among other things, the alcohol enforcement unit monitors alcohol manufacturing, distribution, and sale to the public; issues licenses; provides technical and field assistance to businesses and local units of government; and initiates enforcement actions.

¹⁰ *Minn. Stat.* (2004), §§299L.02, 299L.03, and 299L.06.

¹¹ 25 *U.S. Code*, secs. 2701-21 (2000). The primary federal regulator is the National Indian Gaming Commission. The commission is responsible for ensuring compliance with IGRA and commission regulations. The commission approves tribal gaming ordinances and casino management contracts and has some oversight authority over tribes' use of gaming revenue. Other federal agencies are involved in casino oversight as well. For example, the Department of the Interior determines "federally recognized tribes" that are subject to IGRA, the Federal Bureau of Investigation is involved in certain criminal matters related to gambling, and the Department of the Treasury and Internal Revenue Service impose regulatory requirements.

¹² Compacts are legal, written agreements between a state and a single tribe. Compacts establish state and tribal oversight roles and specify the games allowed. Compacts may also establish standards for the operation of games, specify state laws that will apply to class III gambling, or establish financial payments to the state.

¹³ The state has entered into a total of 22 compacts—separate video game of chance and blackjack compacts with each of the 11 tribes. The terms of the original compacts are virtually identical among tribes. See *Tribal-State Compact for Control of Class III Video Games of Chance*; <http://www.dps.state.mn.us/alcgamb/gamslcmp.html>; accessed August 24, 2004 and *Tribal-State Compact for Control of Class III Blackjack*; <http://www.dps.state.mn.us/alcgamb/gambjcom.html>; accessed August 24, 2004.

The state's authority to oversee Indian casino gambling is defined in "compacts" between the state and each tribe.

Table 1.8: Indian Gaming Classifications and Regulatory Roles as Defined in the Federal Indian Gaming Regulatory Act of 1988

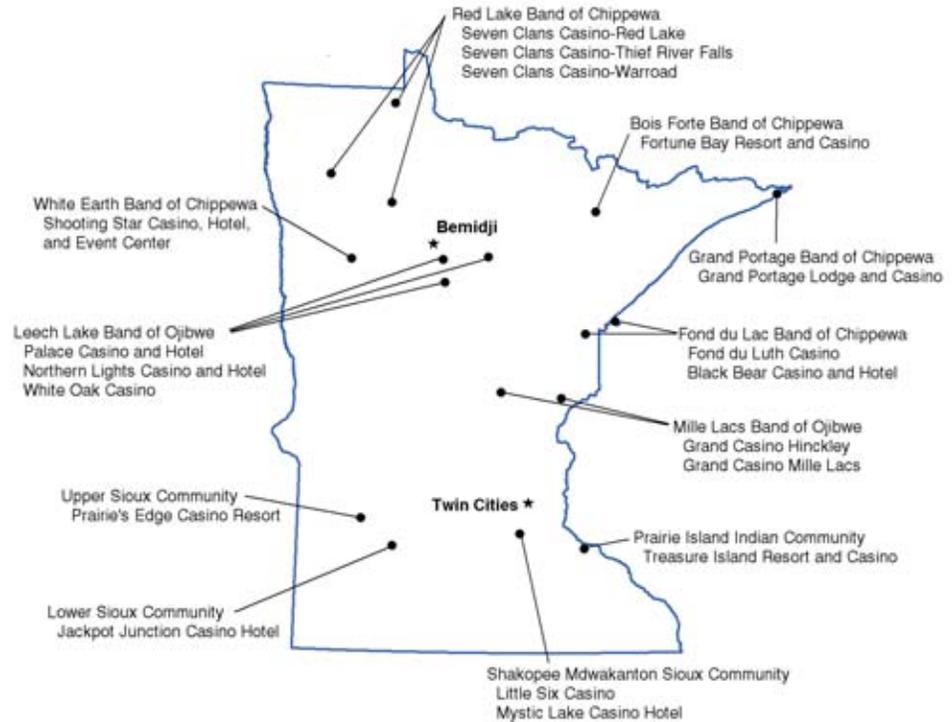
Gaming Classification	Regulatory Authority
<p>Class I</p> <ul style="list-style-type: none"> • Social games played solely for prizes of minimal value • Traditional forms of gaming connected with tribal ceremonies or celebrations 	Indian tribes are the sole regulators
<p>Class II</p> <ul style="list-style-type: none"> • Bingo or lotto played for prizes (including electronic or computerized versions of the games) • Pull-tabs, tip jars, punch boards, instant bingo, and other games similar to bingo • Nonbanking card games, such as poker, that state law authorizes or does not prohibit and that are played legally anywhere in the state 	Indian tribes are the primary regulators, with secondary regulation by the federal government (National Indian Gaming Commission)
<p>Class III</p> <p>All other forms of gaming that are not class I or II including:</p> <ul style="list-style-type: none"> • Any house banking games, such as blackjack • Slot machines and electronic or electro-mechanical facsimiles of any game of chance, such as video poker • Casino games such as craps and roulette • Sports betting and pari-mutuel wagering • Lotteries 	Indian tribes are the primary regulators, with secondary regulation by states, according to the regulatory terms of tribal-state compacts

NOTE: Other federal agencies are involved in casino oversight, including the Treasury, Interior, and Justice departments.

SOURCES: *Indian Gaming Regulatory Act of 1988, 25 U.S. Code, secs. 2701-21 (2000)* and National Indian Gaming Commission documents.

operate 18 casinos around the state. The terms of Minnesota’s tribal-state compacts are discussed in more detail in Chapter 5, but in general, the compacts establish background check and licensing requirements for casino employees, technical standards for the operation of video slot machines and blackjack, and the right of the Minnesota Department of Public Safety to conduct inspections in order to verify compliance with compact provisions. The compacts allow the Commissioner of Public Safety and tribes to negotiate technical amendments to certain compact sections—the hardware and software requirements for video slot machines and regulatory standards for blackjack.¹⁴ Other compact terms can only be renegotiated by mutual agreement of the state and the tribe.

¹⁴ *Tribal-State Compact for Control of Class III Video Games of Chance*, sections 6.9 and 6.10; *Tribal-State Compact for Control of Class III Blackjack*, section 4.

Figure 1.2: Minnesota Indian Casinos, 2004

SOURCE: Office of the Legislative Auditor.

The Alcohol and Gambling Enforcement Division has authority to conduct background and law enforcement investigations related to all gambling in Minnesota.

Background and Criminal Investigations

Background investigations conducted by the Alcohol and Gambling Enforcement Division provide gambling regulators with detailed information relevant to an applicant's suitability for licensure, including financial ownership, criminal history, regulatory history, and other conduct. Most of these comprehensive background investigations are of businesses involved in the gambling industry, and the division generally does six to eight of these investigations a year. In addition, casinos, the Racing Commission, the Lottery, and the Gambling Control Board routinely request arrest and conviction records (over 20,000 requests annually), which are considered when making hiring, licensing, and contracting decisions. The Alcohol and Gambling Enforcement Division acts as an intermediary for these criminal history checks, forwarding requests to the state's Bureau of Criminal Apprehension and, for national criminal history checks, to the Federal Bureau of Investigation.

AGED special agents are the state law enforcement officers who investigate illegal gambling, such as sports bookmaking and Internet gambling, and criminal allegations related to legal gambling, such as drugging of a horse or theft of charitable gambling receipts. The division generally receives over 200 criminal

complaints a year related to both legal and illegal gambling. (Other criminal complaints may go directly to local law enforcement offices.) Gambling-related criminal complaints are referred to the division by the other gambling regulatory agencies or come directly from organizations that conduct gambling, citizens, and other law enforcement offices.

Gambling Control Board

SUMMARY

The Gambling Control Board regulates the large and complex industry of charitable gambling. Although the board's process for reviewing gambling equipment is comprehensive, the board is unable to provide sufficient oversight in other areas. The board does not ensure that only eligible applicants are licensed, and its compliance activities are too infrequent to adequately detect and deter noncompliant or illegal activity. The Gambling Control Board's ability to provide efficient and effective oversight is hampered by poor technology. Regarding distribution of gambling proceeds, in fiscal year 2003, many charitable gambling organizations' gambling business expenses were excessive, and we estimated that over half of charitable gambling's net profits (gross receipts less prizes and business expenses) were consumed by state, federal, local, and real estate taxes and audit and regulatory fees. We recommend that the Gambling Control Board improve its technology, target its resources, and take other steps so that its activities are conducted as effectively and efficiently as possible. In addition, we recommend that the Legislature reconsider the scope and focus of the Gambling Control Board's responsibilities in regulating charitable gambling.

The Gambling Control Board regulates charitable gambling.

The Gambling Control Board is the primary state agency responsible for regulating bingo, paddlewheels, pull-tabs, raffles, and tipboards—the types of gambling known as “lawful” or “charitable” gambling.¹ For the most part, only nonprofit organizations licensed or permitted by the Gambling Control Board can conduct charitable gambling.²

By law, the board is to (1) take all necessary steps to ensure the integrity of and public confidence in charitable gambling and (2) ensure compliance with all applicable laws and rules.³ The board has seven members, five appointed by the Governor and one each appointed by the Commissioner of Public Safety and the Attorney General. An executive director and a staff of about 30 carry out board policy and handle the day-to-day responsibilities of regulating charitable gambling.

¹ The Legislature defined these five forms of gambling as “lawful gambling,” but “charitable gambling” is more commonly used. We use “charitable gambling” in this chapter to prevent confusion between “lawful” and “legal” gambling and to recognize charitable gambling’s fundraising purpose. The board does not regulate these games if they are run by Indian tribes.

² The different categories of charitable gambling are described in Chapter 1.

³ *Minn. Stat.* (2004), §349.151, subd. 4(a)(4) and (17). This subdivision includes several additional powers and duties.

Although the Gambling Control Board is the primary regulatory body for charitable gambling, other state agencies also play roles. The Department of Revenue collects charitable gambling taxes and maintains the state's pull-tab, tipboard, and paddleticket inventory system. The Department of Public Safety's Alcohol and Gambling Enforcement Division investigates alleged charitable gambling crimes. The Attorney General's Office is the board's legal counsel. Local governments also affect charitable gambling that occurs within their jurisdiction through more stringent regulations and requirements about how organizations spend proceeds. A local government can also impose a gambling tax of up to 3 percent of net receipts on organizations conducting charitable gambling within its jurisdiction to cover the costs of local regulatory activities.

This chapter focuses on the Gambling Control Board and addresses the following questions:

- **To what extent does the Gambling Control Board ensure the integrity of charitable gambling?**
- **To what extent does the Gambling Control Board ensure that charitable gambling proceeds are spent appropriately?**

**Over 1,450
licensed
organizations
conduct
charitable
gambling at over
3,000 sites.**

To answer these questions, we reviewed board procedures, interviewed the board chair and staff, and analyzed data on board activities. We also analyzed data from the Department of Revenue, and interviewed staff there and at the Department of Public Safety and the Attorney General's Office. Finally, we met with officials from groups representing nonprofit organizations that conduct charitable gambling and charitable organizations that benefit from the proceeds. As noted in Chapter 1, the board has a regulatory role in most charitable gambling, whether conducted by licensed or unlicensed nonprofit organizations. However, most of the board's resources are focused on licensed organizations, and that is where we targeted our evaluation as well.

This chapter is divided into two main sections. The first section examines the board's efforts to mitigate threats to the integrity of charitable gambling, and the second section focuses on the board's efforts to ensure that money raised through charitable gambling is spent as it should be. Conclusions and recommendations are at the end of the chapter.

INTEGRITY OF CHARITABLE GAMBLING

In fiscal year 2004, people wagered \$1.4 billion on charitable games in Minnesota. Over 1,450 licensed organizations conducted the games at over 3,000 sites throughout Minnesota. As a large, complex, cash-based industry, charitable gambling is vulnerable to abuse, including cheating, theft, and misuse of gambling proceeds. To mitigate these vulnerabilities, the Gambling Control Board: (1) licenses individuals and businesses engaged in charitable gambling; (2) provides a compliance presence through education and mentoring, compliance reviews, site inspections, investigations, and penalties; and (3) approves and tests gambling equipment. After evaluating these board activities, we discuss the

board's use of technology, which affects its ability to provide effective and efficient oversight.

Licensing

Licensing is an important regulatory tool.

The first step in ensuring the integrity of charitable gambling is controlling, through licensing, who can conduct and profit from it. In Minnesota, veterans, fraternal, religious, and other nonprofit organizations can apply for a license to conduct charitable gambling. Licensed organizations include, among others, Veterans of Foreign Wars and American Legion posts, Moose Lodges and Knights of Columbus chapters, firemen's relief associations, local youth hockey and football booster clubs, churches, and 501(c)(3) organizations.⁴

Licensing is an important element to ensuring the integrity of charitable gambling because a license provides the means through which the board can penalize people or businesses for impropriety. In addition, licensing allows the Gambling Control Board to prevent people or businesses that might compromise the integrity of charitable gambling from working in the industry in the first place. In order for licensing to do the most good, all people and businesses that could harm charitable gambling should be subject to licensure and only eligible people and businesses should be licensed. With this in mind, we examined whom the board licenses and the board's licensing procedures.

Regarding the scope of the board's licensing authority, we found that:

- **Compared to other gambling regulators in Minnesota, the Gambling Control Board's licensing authority is limited to a fraction of the people who could harm the integrity of charitable gambling.**

Of the myriad people engaged in the management and conduct of charitable gambling—including about 1,500 gambling managers, over 20,000 paid employees in fiscal year 2004, and an unknown number of volunteers—the Gambling Control Board only has the authority to license gambling managers. Table 2.1 lists the individuals and entities licensed by the board to participate in charitable gambling. In contrast, the Racing Commission licenses all racetrack owners, vendors, and employees. Although the state's tribal compacts require licensing only of employees involved in the operation and management of casino games, at the casinos we visited, virtually every employee was licensed, not just those involved in the conduct of games. As we discuss in more detail later, the board is operating under tight resource constraints, and expanding the scope of its licensing authority may not be a viable option at this time. Still, it is important that the board use its existing licensing authority effectively.

But the board's licensing authority is limited.

Where it does have authority to license, the board needs to ensure that only eligible individuals and businesses are licensed. For example, state law requires that gambling managers (1) attend charitable gambling training and pass an exam; (2) have never been convicted of a criminal violation involving fraud, theft, tax evasion, misrepresentation, or gambling; and (3) have never been convicted of

⁴ Organizations commonly referred to as "501(c)(3) organizations" are tax-exempt under section 501(c)(3) of the Internal Revenue Code.

Table 2.1: Licenses and Permits Issued by the Gambling Control Board, FY 2004

	<u>Licenses or Permits Issued</u>
Licenses	
Manufacturers	8
Distributors	18
Distributor Salespeople	165
Bingo Halls	11
Nonprofit Organizations	1,468
Gambling Managers	1,542
Permits	
Premises Permits to Licensed Organizations	3,069
Permits to Conduct Exempt Activities ^a	2,888
Permits to Conduct Excluded Activities ^b	1,534

^aLawful gambling activities are “exempt” if the organization conducts the activities on five or fewer days in a calendar year and does not award more than \$50,000 in prizes.

^bSmall and infrequent bingo events or raffles are “excluded” charitable gambling. For example, bingo is an excluded activity if the nonprofit organization conducts four or fewer bingo occasions a calendar year. Raffles are excluded if the total value of raffle prizes awarded by the organization does not exceed \$1,500 a calendar year.

SOURCE: Gambling Control Board licensing data.

assault, a criminal violation involving the use of a firearm, or making terroristic threats.⁵ Criteria for an organization license include that (1) the organization is a nonprofit that has been in existence for at least three years and (2) no officer or member of the organization’s governing body has been convicted of a felony or gross misdemeanor within five years, has ever been convicted of a gambling crime, or has had a gambling license permanently revoked.⁶

To determine if the board is licensing only eligible people and organizations, we reviewed eligibility criteria for gambling managers and organizations and the licensing procedures that the board follows. We found that:

- **The Gambling Control Board does not ensure that only eligible gambling manager applicants and nonprofit organizations are licensed.**

Our review of the board’s licensing process revealed that the Gambling Control Board does not verify that all requirements for licensure are met before issuing or renewing gambling manager and organization licenses. Although many types of criminal convictions are grounds for mandatory disqualification for a gambling manager’s license, the background checks conducted on applicants do not include the applicants’ entire criminal record. Because the board does not submit fingerprints for background checks, the checks cover applicants’ criminal history only in Minnesota. In addition, the board does not request background checks of

The board's background checks do not cover an applicant's entire criminal history.

⁵ *Minn. Stat.* (2004), §§349.155, subd. 3(a) and 349.167, subds. 2, 4, and 7. These sources contain additional requirements and restrictions as well.

⁶ *Minn. Stat.* (2004), §§349.155, subd. 3(b) and 349.16, subd. 2(b). These sources contain additional requirements and restrictions as well.

Although required by law, the board has not established operating standards that certain licensed organizations must meet.

organizations' officers and governing body before issuing or renewing an organization license even though some criminal violations by these people are cause for mandatory disqualification. Instead, the board requires the organizations' chief executive officers and treasurers to sign sworn affidavits that they have not been convicted of the violations.

We found one instance in which the board has not established licensing criteria that we think it should. Statutes direct the board to establish "operating standards" that any licensed 501(c)(3) organizations must meet, including maximum percentages of total expenditures that the organization may spend on administration and operation.⁷ We believe this statutory language creates an implicit licensing criterion, but the board has not established such standards. To estimate the impact that operating standards would have on licensing, we applied a common standard of nonprofit accountability to current licensees, namely that at least 70 percent of an organization's annual expenses should be for program activity and not more than 30 percent should be for general, management, and fundraising costs.⁸ We determined that, of 84 licensed 501(c)(3) organizations for which we found information, 23 had administrative expenditures exceeding the standard.⁹ In other words, over one-quarter of these organizations would not have been licensed if the board had adopted the standard we used.

Although we identified these deficiencies in the board's licensing process and criteria, we do not know the degree to which they have negatively impacted charitable gambling. We do not know the number of applicants inappropriately licensed due to the board's failure to conduct thorough background checks or their effect on charitable gambling. Similarly, while our analysis indicated that over 25 percent of the 501(c)(3) organizations we checked would not have been licensed under a common standard of accountability, the organizations may not have caused harm.

Compliance Presence

Another element in ensuring the integrity of charitable gambling is making sure that organizations and individuals conducting gambling comply with statutes and rules. The Gambling Control Board promotes organizations' compliance by (1) providing education and mentoring; (2) conducting compliance reviews, site inspections, and investigations; and (3) issuing penalties. Through education and mentoring, the board encourages self-regulation, the theory being that licensees will comply with laws and rules if they understand them. Through compliance

⁷ *Minn. Stat.* (2004), §349.154, subd. 1.

⁸ Charities Review Council, *Charities Review Council Accountability Standards*; <http://www.crcmn.org/standards/index.htm>; accessed October 8, 2004. The board uses a similar standard for 501(c)(3) organizations' expenditures of gambling gross profits, excluding business expenses.

⁹ We looked for expenditure information for 501(c)(3) organizations that were among a sample of 307 licensed organizations that we had selected for another purpose. Of the 307 organizations, 101 had a 501(c)(3) status, 157 had a different 501(c) status, and for 49 organizations, we could not determine a tax status. We found expenditure information for 84 of the 101 501(c)(3) organizations. We could not find expenditure information for the remaining 501(c)(3) organizations either because the organizations were not required to file the Internal Revenue Service tax form from which we obtained financial information or because our sources for obtaining the tax forms did not have recent or any tax forms for some of the organizations.

reviews and site inspections, board staff identify noncompliant activities. Together with investigations, compliance reviews also provide a deterrent effect by creating the perception that violators will be caught. Penalties are important because they let licensees know that there are consequences to noncompliance.

After reviewing the board's compliance activities, we found that:

- **Overall, the Gambling Control Board's compliance activities are insufficient to systematically detect and deter noncompliant or illegal activity.**

In spite of board efforts, staff at the board and the departments of Revenue and Public Safety believe that problems in charitable gambling are increasing. Cases opened by board investigators increased from 135 in calendar year 2002 to 173 in 2003 and will exceed 200 by the end of 2004 if the second half of the year keeps pace with the first. And, after going several years without charitable gambling audits leading to criminal charges, between July 2003 and October 2004, the Department of Revenue concluded two audits resulting in criminal charges and was completing another with potential criminal charges. In addition, the board's chair and others we interviewed believe that the board does not have a compliance presence sufficient to deter noncompliant or illegal activity.

Staff reductions make it difficult for the board to have a stronger compliance presence.

According to the board, resource reductions have affected the board's ability to provide a greater compliance presence. The board's staff complement dropped from 35 in fiscal year 2000 to 29 in fiscal year 2004. The board accommodated these cuts by adding one supervisory position in the compliance area and cutting almost seven non-supervisory positions for administration, licensing, and investigation. In addition, according to the director, the budget process and resulting staff cuts required the board to prioritize and make changes to its work processes—some of which directly affected compliance activities. For example, the board reduced its travel budget so it could maintain a compliance staff position, focused compliance reviews on fewer items,¹⁰ and significantly reduced the practice of reviewing compliance findings with organizations at the organizations' offices.

In the following sections, we discuss each of the board's efforts to promote compliance and where these efforts are lacking.

Education and Mentoring

One way to prevent compliance problems from occurring in the first place is through education and mentoring. The Gambling Control Board does this by providing training for gambling managers, publishing the *Lawful Gambling Manual*, distributing a bimonthly newsletter, and maintaining a website. The board also provides informal one-on-one assistance to gambling managers that need or request it.

We focused on education that the board provides through its gambling manager seminar and continuing education classes. By law, gambling managers must

¹⁰ According to the board, specialists continue to conduct expanded reviews of new gambling organizations and organizations that have serious problems or seem to need more review.

The board uses education to help prevent compliance problems.

complete a class (the gambling manager seminar) and pass an exam before being licensed and must attend continuing education or pass an exam before their licenses can be renewed. The chief executive officers of newly licensed organizations also are required to attend the gambling manager seminar. We found that:

- **The Gambling Control Board is unable to provide enough continuing education classes for gambling managers and does not require training of all gambling organizations' chief executive officers.**

The Gambling Control Board is concerned about charitable gambling education in two areas: 1) availability of classes and 2) requirements for chief executive officers. We share the board's concerns. First, the board would like to offer more continuing education classes throughout the state. Continuing education requirements sometimes pose challenges for gambling managers, particularly for organizations located in outstate Minnesota. According to one person we interviewed, it is not uncommon for gambling managers to drive over two hours each way to attend a two-hour continuing education class. In 2004, the Gambling Control Board offered 25 continuing education classes around the state, in addition to offering classes at the Allied Charities of Minnesota convention. The board would like to offer five additional classes—one centrally located and one in each "corner" of the state.

Training requirements are focused on gambling managers.

Second, only chief executive officers (CEOs) of charitable gambling organizations being licensed for the first time must attend training; there are no education requirements for new CEOs of already-licensed organizations. The board would like to create education requirements for new CEOs, regardless of whether the organization is new to charitable gambling. We support the board in this effort because chief executive officers are legally responsible for their organizations' charitable gambling operations. It is important that they understand the role they and other organization members should play in overseeing their charitable gambling accounts and activities.

Compliance Reviews, Site Inspections, and Investigations

While education and mentoring aim to prevent problems, compliance reviews, site inspections, and investigations allow the board to identify noncompliance. During compliance reviews, Gambling Control Board specialists review licensed organizations' records to determine the organizations' adherence to charitable gambling laws. Compliance specialists and investigators conduct site inspections with the same purpose in mind. In addition, specialists and investigators follow up on allegations of rule and law violations.

We interviewed board staff about compliance activities, reviewed documents and procedures, and analyzed board data and found that:

- **The Gambling Control Board does not complete enough compliance reviews, site inspections, and assessments of allegations.**

Because of these limits in the board's compliance activity, the board is not able to detect compliance problems early or create the deterrent effect it would like.

The board is not meeting its goal of reviewing each organization involved in charitable gambling every two years.

Given its current rate of activity, the Gambling Control Board is not meeting its current goal of conducting a compliance review of each organization every two years.¹¹ Typically, a compliance specialist completes a review at his office using documents delivered by the organization and tax return and inventory data retrieved from the Department of Revenue. Documents provided by the organization include, among other things, inventory records, bank statements, and game records. As Table 2.2 shows, between 2001 and 2003, the board increased the percentage of organizations it reviewed each year. Still, in 2003, board staff conducted compliance reviews at an estimated rate of one per organization every 2.7 years. Of the 1,376 organizations licensed for all of fiscal year 2003, at least 56 organizations will have gone over three years between reviews by the time their next review is conducted. Examples of items that might be revealed during a compliance review include missing inventory records, late bank deposits, ineligible expenditures of gambling funds, and cash shortages. Table 2.3 lists the items most frequently noted by specialists during compliance reviews.

Table 2.2: Gambling Control Board Compliance Reviews, 2001-03

	<u>2001</u>	<u>2002</u>	<u>2003</u>
Number of Licensed Organizations	1,506	1,460	1,431
Number of Compliance Reviews Completed ^a	501	503	540
Percentage of Organizations Reviewed	33%	34%	38%
Estimated Years Between Reviews	3.0	2.9	2.7

^aFigures include reviews completed by the cities of Minneapolis and St. Paul.

SOURCE: Office of the Legislative Auditor analysis of Gambling Control Board compliance review data.

Infrequent reviews allow problems to go undetected too long.

That the board conducts compliance reviews infrequently and is not meeting its compliance review goal has several implications. First, infrequent reviews allow problems to go undetected too long, possibly resulting in repeated but unintentional violations. Second, infrequent reviews provide less of a deterrent effect than more frequent reviews because people believe that they will not be caught. Third, infrequent reviews make it more difficult for the board to identify organizations with repeat violations and issue penalties against them. Finally, under the current review rate, an organization could complete its entire two-year licensing period without a review, and the board's executive director could renew its license unaware of instances of noncompliance. According to Minnesota rules, the board is supposed to deny a renewal application if the director determines that the organization is not in compliance with a law or rule governing charitable gambling.¹²

¹¹ According to the board's strategic operation plan, its ultimate goal is to conduct reviews annually.

¹² *Minn. Rules*, ch. 7861.0020, subp. 8(B)(3)(a); <http://www.revisor.leg.state.mn.us/arule/7861/0020.html>; accessed December 2, 2004.

Table 2.3: Types of Noncompliance Most Frequently Noted During Compliance Reviews, January 2003 - June 2004

	Reviews Noting Item (of 798 Reviews)	Percentage of Reviews
Prize receipts not in compliance	404 ^a	51%
Charitable contributions questionable	371	46
Game records not on required forms	366 ^a	46
Gambling fund reconciliation inaccurate ^b	261	33
Business expenses questionable	230	29
Physical inventory records inaccurate	214	27
Separation of duties insufficient ^c	184	23
Monthly tax returns inaccurate	175	22
Deposits not made in four business days	160	20
Deposit records insufficient	156	20

^aApplies only to pull-tabs, tipboards, and paddlewheels.

^bOn a monthly basis, organizations must compare their gambling “net worth” as reflected by their assets (excluding capital assets) and liabilities with their “net worth” as calculated on their monthly tax return. If the two measures of net worth do not match or cannot be supported by an organization’s records, the compliance specialist will note this item.

^cSeparation of duties is the concept that no one person should have complete control over any transaction from beginning to end. For example, pull-tab sellers should not be allowed to audit the pull-tab games they sold.

SOURCE: Office of the Legislative Auditor analysis of Gambling Control Board compliance review data.

Some noncompliance can be detected only during on-site inspections.

By doing too few site inspections, board staff are likely missing noncompliant activity that can only be detected in person. Site inspections allow board staff to see the conduct of games in play and review records on site, providing a different perspective than that provided by compliance reviews. For example, we accompanied specialists on several site inspections and noted unsecured inventory at one site and, at another site, containers of active pull-tab games that were not secured when the pull-tab booth was temporarily left unattended by the seller. Both of these violations provided opportunities for theft and, ultimately, less money for charities. Prior to January 2003, compliance specialists met with organization representatives at the organizations’ offices to review the findings of compliance reviews and resolve outstanding questions or issues. At the same time, the specialists would complete inspections of as many of the organizations’ charitable gambling locations as possible. Now, most compliance review reports are mailed to the organizations and, with less time “in the field,” staff complete fewer inspections of gambling sites.

Furthermore, the board’s compliance officer told us that an allegation backlog has developed, although he was unable to quantify its extent. According to the board, its investigators are unable to investigate allegations as quickly as they once could because they are attending to other responsibilities, such as conducting site inspections. Timely response to allegations is important to catching problems while they are happening and either resolving them or pursuing more in-depth investigations.

Penalties

Penalties are the final element of regulation. If education and mentoring have not helped a licensee to comply with laws and rules, and compliance reviews, site inspections, or investigations have identified serious or recurring violations, the licensee must be held accountable. The executive director of the Gambling Control Board can issue citations of up to \$500 for violations of statutes or rules. The Compliance Review Group (CRG), a committee of the board, can issue stronger penalties, subject to ratification by the full board, including larger fines and license suspensions or revocations. According to board staff, the executive director uses citations for licensees with one or several closely related violations, whereas licensees with numerous violations are referred to the CRG. As shown in Table 2.4, the CRG issued 55 suspensions, revocations, and civil penalties to organizations in fiscal year 2004, while the executive director issued 87 citations.

The board can impose a range of penalties.

Table 2.4: Penalties Issued by the Gambling Control Board to Licensed Organizations, FY 2002-04

	<u>FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>
Citations Issued by the Executive Director	35	57	87
Penalties Issued by the Compliance Review Group			
License Revoked	2	3	3 ^a
License Suspended	7	10	7
Premise Permit Revoked ^b	3	2	5
Premise Permit Suspended ^b	8	3	8
Civil Penalties	23	22	32

NOTES: Counts are of penalties, not organizations. Organizations may receive more than one type of penalty or citation.

^a Includes one license relinquished by the organization.

^b A premise permit is issued to an organization for each charitable gambling site it operates.

SOURCE: Office of the Legislative Auditor analysis of Gambling Control Board data on citations and Compliance Review Group activities.

To be effective and fair, penalties must be used, and used consistently. In reviewing the board's use of penalties, we focused on citations, the least severe penalty, because they are used more frequently than the more severe penalties and affect a greater number of organizations. Based on our analysis of citation data, we found that:

- **The Gambling Control Board makes inconsistent and insufficient use of citations, although the board has taken steps to improve both.**

The board does not have a process to ensure that staff request citations under similar circumstances. We analyzed the number of citations requested by compliance specialists in fiscal years 2003 and 2004. We found that two specialists requested no citations during the two-year period, while the number of citations requested by others ranged from 2 to 14. Although circumstances at

organizations differ widely, such a range in the use of citations suggests that staff make inconsistent use of this tool. Interviews with board staff support this conclusion. Staff said that specialists might handle situations differently, for example, depending on the specialists' familiarity with an organization or if only one of an organization's gambling sites has problems. To its credit, in December 2002, the board changed specialists' assigned organizations in order to avoid "familiarity issues." We think it is important, to the greatest degree possible, that organizations in similar circumstances be treated similarly.

Although the board has not developed a process that ensures that staff request citations under similar circumstances, the board created a citation request and approval process in May 2003 to help ensure that organizations that are recommended for a citation receive similar financial penalties for similar offenses. Board staff who believe a licensee should be cited for a violation complete a form describing why the licensee should be cited and assign points to the request based on severity, culpability, frequency, actual harm, and other factors. The compliance supervisor, in consultation with the compliance officer, reviews the requests to ensure consistency among them. The executive director has final approval over the requests.

Since creating the new citation request process, the number of citations issued by the board has increased. According to data provided by the board, the board issued 48 citations in the 12 months preceding implementation of the new process. In the subsequent 12 months, the board issued 90 citations. Board staff believe several things have contributed to the increase in citations issued, including: (1) the new process is easier and less bureaucratic than the old process, so staff may be using it more; (2) the board has started issuing citations to organizations that repeatedly file incomplete reports; and (3) the compliance supervisor has become more aware of when citations are appropriate and may suggest to staff that they request citations in some circumstances.

Citations issued by the board increased after it created a new process in 2003.

Although the number of citations issued by the board has increased, we think that the board may still be missing opportunities to use citations to encourage organizations to improve the way they do business. We identified organizations that appeared to have ongoing cash shortages to see if the board issued citations to them. (A cash shortage occurs when the cash deposited from a charitable gambling activity is less than what it should be.) We tested use of citations for cash shortages because they can indicate that an organization has problems ranging from poor internal controls to theft. Compliance specialists check for cash shortages during compliance reviews, and we could track them with organizations' tax data. We focused on 12 organizations that specialists identified as having excessive cash shortages in reviews conducted between October 2002 and August 2003 and that, in our opinion, continued to have cash shortage problems.¹³ Of the 12 organizations we reviewed, only 1 was recommended for a citation. An additional organization was under criminal investigation, so the board was postponing use of civil penalties. According to the board, a third organization was reporting incorrectly and did not have actual cash shortages.

¹³ It is generally accepted that cash shortages above 0.3 percent may indicate a problem. Statute allows organizations to claim cash shortages of up to 0.3 percent of gross receipts as an allowable expense. We determined that organizations had ongoing problems with cash shortages at the site or organization level if at least half of the months we examined had shortages in excess of 0.3 percent.

Game Review and Testing

Another element in ensuring the integrity of charitable gambling is ensuring the physical integrity of the games. Integrity of charitable gambling equipment means that the equipment is produced in compliance with laws and rules and in such a way that all players have an equal chance of winning. Table 2.5 describes various types of charitable gambling equipment, which include pull-tabs, pull-tab dispensing machines, jar tickets, tipboards, bingo paper, bingo ball selection devices, paddlewheels, and paddlewheel tickets.

Table 2.5: Charitable Gambling Equipment

Bingo Ball Selection Device	The device used to select letter and number combinations corresponding to combinations appearing on bingo paper.
Bingo Paper	Paper sheets or hard cards that have five horizontal rows of spaces with each row except one having five numbers. The center row must have four numbers and the center space marked "free." Each column must have one of the letters B-I-N-G-O in order at the top. Bingo paper sheets may also have numbers that are not preprinted but are filled in by players.
Jar Ticket	A single pull-tab ticket which is folded and banded.
Paddlewheel	A wheel marked off into sections containing one or more numbers, and which, after being turned or spun, uses a pointer or marker to indicate winning chances.
Paddleticket	A preprinted ticket that can be used to place wagers on the spin of a paddlewheel.
Pull-tab	A single folded or banded ticket or a multi-ply card with perforated break-open tabs, the face of which is initially covered to conceal one or more numbers or symbols, where one or more of each set of tickets or cards has been designated in advance as a winner.
Pull-tab Dispensing Device	A mechanical device that dispenses paper pull-tabs and has no additional function as an amusement or gambling device.
Tipboard	A board, placard or other device containing a seal that conceals the winning number or symbol.

SOURCES: *Minn. Stat.* (2004), §§349.12 and 349.17, subd. 6; *Minn. Rules* (2003), 7861.0010, subp. 32; and Office of the Legislative Auditor.

Manufacturers submitted almost 4,000 pieces of gambling equipment for board review in fiscal year 2004.

To help insure the physical integrity of the games, Gambling Control Board staff review and test gambling equipment. To evaluate the board's product review and testing process, we focused on pull-tabs because they account for the bulk of charitable gambling activity and 99 percent of the 3,946 pieces of gambling equipment manufacturers submitted for review in fiscal year 2004. We interviewed board staff, reviewed board procedures, and analyzed product testing and inventory data and found that:

- **The board has a comprehensive pull-tab review process and has worked with manufacturers to improve the integrity of pull-tab games.**

The board tested all pull-tab games submitted for testing in fiscal year 2004.

The board’s pull-tab review process consists of (1) review and approval of the artwork and structure of all new games and (2) physical tests of samples of games. The board’s approval and testing process for pull-tabs, described in Table 2.6, gives the board the opportunity to check games’ appearance, payout structure, and initial manufacturing process for adherence to standards in rule. The board would like to test more pull-tab deals than it currently does, but based on our review of board records, the board was able to test all of the pull-tab games that manufacturers submitted for testing in fiscal year 2004.

Table 2.6: Gambling Control Board’s Pull-tab Review and Testing Process

Definitions

	Definition	Example
Family	A group of pull-tab games that have the same name and manufacturer	Neptune’s Treasure is a family consisting of 13 different pull-tab games. Each game has a different structure and is identified by a unique form number.
Game	A unique combination of manufacturer, game name, number of tickets, ticket price, and payout structure	One of the 13 Neptune’s Treasure pull-tab games is Form B366. It has 2,519 tickets with a \$1.00 ticket price and 78 percent payout. A version of Neptune’s Treasure with a different number of tickets, price, or payout structure is a different game and has a different form number.
Deal	One boxed copy of a pull-tab game	The manufacturer will produce several deals of the Neptune’s Treasure game for sale to different charitable gambling organizations.

Pull-Tab Review and Testing

	When Tested	What Tested
Game	Before the manufacturer sells a new pull-tab game in Minnesota	Gambling Control Board staff review the game’s artwork and payout structure for compliance with statutes and rules. Staff also check for offensive content.
Deal	When the manufacturer first ships a new family of games into Minnesota	Gambling Control Board staff check the deal’s compliance with Minnesota standards and the approved game, and try to identify winning and losing tickets without opening the pull-tabs.

SOURCE: Office of the Legislative Auditor.

In addition to its routine review and testing, the board has identified issues that affect integrity across pull-tab games and taken steps to eliminate them. Recently, the board worked with manufacturers to add pull-tab production standards to Minnesota rules to help reduce cheating. For example, one form of cheating—“peeking”—involves bending a pull-tab or cracking the perforations around the tabs just enough to see under the tabs and determine whether the pull-tab is a winner. Among other things, the new production standards require the game symbols indicating whether a pull-tab is a winner to be printed a certain distance from the perforation to make peeking more difficult.¹⁴

Technology

Adequate computer hardware, software, and technological capacity among staff are critical to providing efficient and effective oversight. With these tools, the Gambling Control Board could analyze industry trends, target resources, supplement activities with electronic monitoring, and reduce paper processing. For example, board staff occasionally conduct ad hoc analyses of organizations’ tax data to identify problem organizations, but with greater technological resources, staff could use organizations’ monthly tax returns to regularly identify organizations that might benefit from an increased compliance presence. Our review of organizations that were licensed for all of fiscal year 2003 identified 310 organizations (23 percent) that had cash shortages at the organization or site level that exceeded 0.3 percent, a level based in statute and generally agreed to indicate possible problems. However, given the board’s compliance review rate, it likely reviewed only 30 to 40 percent of these organizations because it does not systematically analyze data to target compliance resources. Instead, the board initiates most of its compliance reviews based on the date an organization was last reviewed.

Strategic use of data and technology is critical to efficient and effective oversight.

Regarding the board’s technology, we found that:

- **The Gambling Control Board’s ability to provide efficient oversight is hampered by its technology and information systems.**

There are several problems with the board’s technology resources that limit their usefulness. First, the board’s computer systems do not centrally store comprehensive information on licensed organizations. Second, the board has had limited access to tax and inventory data maintained by the Department of Revenue. Finally, organizations cannot file reports or apply for a license electronically.

For the most part, the board’s information on licensed organizations is scattered among the board’s divisions, making it difficult to access and analyze. In the 1998-99 legislative session, the board requested an appropriation to develop a database that would contain comprehensive information on licensed organizations and allow for electronic licensing and reporting. But absent ongoing funding, the

¹⁴ *Minn. Rules*, ch. 7864.0030, subp. 1; <http://www.revisor.leg.state.mn.us/arule/7864/0030.html>; accessed December 2, 2004.

The board's electronic licensing and compliance data files are segregated, making them difficult to share and analyze.

database was not completed.¹⁵ (At this time, it contains primarily licensing information.) Even though board staff have created electronic files to document activity over which they have responsibility, the files are not available to other board staff who might benefit from the information they contain. For example, the supervisor who oversees compliance specialists has created separate files with information on (1) allegations, (2) compliance review results, (3) incomplete reports of charitable contributions, (4) questionable charitable contributions, and (5) citations. Investigators maintain electronic investigation logs and the compliance officer has created a file documenting penalties resulting from Compliance Review Group conferences. Staff share with each other information that they deem appropriate, but this segregation of data makes it more difficult for board staff to get a complete picture of an organization's operations and problems.

In addition, information sharing between the Department of Revenue and the Gambling Control Board is critical but has been hampered by incompatible software and the board's inadequate hardware. As a consequence, the Department of Revenue does not have direct access to the licensing data it needs from the board for tax purposes, and the board has had limited access to organizations' tax return and inventory data, maintained by the Department of Revenue. During the course of our evaluation, the board's direct access to data at the Department of Revenue improved, but was still limited to a small number of board staff.¹⁶ Tax data, combined with board data, could allow the board to identify problem organizations, analyze industry trends, and do some electronic monitoring.

Finally, the board's computer system does not allow organizations to electronically file reports and license applications. Paper processing reduces efficiency and limits the board's ability to analyze information in a systematic way. For example, the almost 1,500 licensed organizations file monthly reports with the board itemizing their charitable contributions. These reports range from a few lines to several pages in length, and staff regularly review them for completeness and appropriateness of the contributions. We estimated that it took board staff an average of about three months from the filing deadline until they followed up with the organizations about questionable contributions, and over a month after that to finally resolve the questions. In other words, on average, board staff contacted organizations about January contributions in late May, and the issues were not resolved until late June.¹⁷ Electronic filing could allow for automatic rejection of incomplete reports and easier analysis of the data.

The board is developing plans to improve its technology.

To the board's credit, it recognized the limitations of its data systems and, during the course of our evaluation, developed a plan to use its fiscal year 2004 budget carry forward to create a system that would allow for online licensing and reporting and provide board staff with greater access to more information on organizations. The state's InterTechnologies Group (ITG) gave the board approval to proceed with the plan and is continuing to work with the board on its

¹⁵ According to the board's director, the board requested supplemental funding for computer development during the 2003 legislative session, but the request was denied. The director also said that the board was able to replace some of its hardware with surplus equipment from the Lottery.

¹⁶ According to the Department of Revenue, even this limited access for board staff has reduced the department's workload fulfilling board requests.

¹⁷ In some cases, the process took a long time because board staff had to contact organizations more than once before getting a satisfactory response.

development. In addition, the board is exploring the possibility of tapping ITG's expertise on an ongoing basis, as the board's own technological expertise is limited.

CHARITABLE GAMBLING PROCEEDS

By law, gross profits of charitable gambling—or gross receipts less prizes—“may be expended only for lawful purposes or allowable expenses.”¹⁸ For the most part, allowable expenses are charitable gambling's “cost of doing business.” They include rent, compensation, gambling products and devices, accounting and bank services, and utilities, among other things.¹⁹ Lawful purpose expenditures are typically those expenditures more commonly referred to as charitable contributions. As discussed in Chapter 1, while charitable gambling in Minnesota generated \$1.4 billion in gross receipts in fiscal year 2004, \$257 million remained in gross profits to cover business expenses, taxes, and charitable contributions. In the following sections, we examine how organizations spend charitable gambling's gross profits.

Business Expenses

Charitable gambling is a business. Nevertheless, the amount of money consumed by business expenses in the conduct of charitable gambling is a sensitive issue because, to the extent that gambling receipts are spent on business expenses, less money is available for charities. However, according to the board and an industry representative, as the cost of running gambling increases, organizations have a more difficult time staying within the expense limits in statute. For most types of charitable gambling, organizations can spend up to 55 percent of gross profit on business expenses.²⁰ If organizations exceed the limit, they must stop gambling until they have reimbursed their gambling accounts from non-gambling funds.²¹ The Legislature further limits the amount that organizations can spend on business expenses by requiring, in most circumstances, that organizations pay for all gambling expenses with money in their gambling accounts.²²

As we showed in Chapter 1, business expenses for charitable gambling overall reached about \$126 million in fiscal year 2004, or about 49 percent of gross profits. As shown in Table 2.7, compensation accounted for the greatest share of gambling business expenses in fiscal year 2004, reaching \$62 million

For most types of charitable gambling, organizations can spend up to 55 percent of gross profit on business expenses.

¹⁸ *Minn. Stat.* (2004), §349.15, subd. 1.

¹⁹ Compensation includes gambling employee wages, payroll taxes, benefits, and bonuses.

²⁰ For bingo, up to 70 percent of the gross profit less relevant taxes can be spent on business expenses. (*Minn. Stat.* (2004), §349.15, subd. 1.) Charitable gambling business expenses are limited to costs that the organization incurred that were directly related to the conduct of gambling. (*Minn. Stat.* (2004), §349.12, subd. 3a.) For example, if an organization advertised its bingo events and other non-gambling events in a newspaper, the organization could use gambling funds only for the portion of the advertisement's cost corresponding to the portion of the advertisement that related to gambling.

²¹ *Minn. Rules*, ch. 7861.0120, subp. 5(B)(2)(C); <http://www.revisor.leg.state.mn.us/arule/7861/0120.html>; accessed December 2, 2004.

²² *Minn. Stat.* (2004), §349.19, subd. 2.

Table 2.7: Charitable Gambling Organizations’ Business Expenses, by Type of Expense, FY 2004

Type of Expense	Amount	Percentage of Grand Total	Average
Compensation and Payroll Taxes	\$62,071,066	49.1%	\$41,940
Cost of Goods Sold	25,182,938	19.9	17,015
Rent	23,978,859	19.0	16,202
Miscellaneous ^a	5,679,521	4.5	3,838
Accounting Services and Legal Work	4,657,629	3.7	3,147
Gambling Devices and Office Furniture/Equipment	2,295,330	1.8	1,551
Cash (Long) or Short	1,680,373	1.3	1,135
Utilities	1,154,167	0.9	780
Theft and Liability Insurance	873,788	0.7	590
Advertising Expenses	561,723	0.4	380
Gambling Manager Bond and Local Investigative Fee	464,982	0.4	314
Penalties and Interest on Taxes	28,589	0.0	19
Subtotal	\$128,628,964		\$86,911
Offsetting Reimbursements			
Reimbursement for Excess Allowable Expenses ^b	-\$1,703,504	-1.3	-\$1,151
Reimbursement for Excess Cash Short ^c	-\$547,504	-0.4	-\$370
Grand Total	\$126,377,955	100.0%	\$85,391

Compensation and payroll taxes were the largest business expenses for organizations involved in charitable gambling.

NOTES: Table is based on data for 1,480 licensed organizations. Total may not sum due to rounding.

^aMiscellaneous includes bank service charges; office supplies; costs for authorized charitable gambling classes; storage, trash removal, and cleaning expenses; and miscellaneous.

^bCertain organizations that overspend their business expense limit must reimburse their gambling account from non-gambling funds.

^cOrganizations must reimburse their gambling accounts from non-gambling funds for cash shortages in excess of 0.3 percent of gross receipts. Bar owners are required to reimburse organizations for 100 percent of cash shortages at bar operations.

SOURCE: Office of the Legislative Auditor analysis of Department of Revenue charitable gambling tax data.

(49 percent). The next two largest categories of business spending, accounting for about 20 percent each, were the cost of goods sold and rent.

To determine the extent to which licensed organizations stay within expense limits, we analyzed data for the 1,376 organizations that were licensed for all of fiscal year 2003. We found that:

- **In fiscal year 2003, many charitable gambling organizations had excessive gambling business expenses.**

Organizations can exceed business expense limits on an annual basis and still be compliant with state law, but spending too much on business expenses is of concern because (1) less money is available for charities; (2) it violates what we

Because of complexities in law and rule, organizations can exceed business expense limits on an annual basis.

think is the intent of the law; and (3) it raises issues of fairness among organizations conducting charitable gambling.

The board's rules permit charitable gambling organizations to exceed spending limits on an annual basis, while maintaining compliance with state law, in two ways. First, the board determines compliance with spending limits based on an organization's cumulative gross profits and business expenses. In other words, frugality in early years allows organizations to overspend in later years. Second, because organizations are required to reimburse their gambling accounts with non-gambling funds when they exceed the cumulative spending limit, an organization can overspend as long as it has another source of revenue to reimburse its account. While organizations can overspend and remain compliant, we think their business practices violate the intent of the law limiting business expenses. Fiscal year 2003 tax data for organizations that were licensed for the full year showed that, measured on an annual basis, 592 organizations (43 percent) exceeded their business expense limits.²³ Of the 592 organizations, 127 exceeded their respective limits by over 25 percent. We estimated that organizations that exceeded the spending limit by over 25 percent spent, on average, four to five times the amount to raise a dollar for lawful purposes than organizations that spent within the limit.²⁴

When organizations are within business expense limits only because compliance is determined on a cumulative basis, less money may be going to charities. For example, one organization spent under its expense limits in its early years to such an extent that it had a positive expense balance over \$500,000 in 1993. Over the next 10 years, the organization's business expenses were such that the balance was gone by July 2003. If compliance were measured on an annual basis, the organization spent over \$117,000 more on business expenses than it should have in fiscal year 2003, while contributing about \$4,000 to charity.²⁵ In fiscal year 2004, this organization appeared to have contributed more money to charitable causes, but still incurred business expenses in excess of its limit by about \$62,500.²⁶

Organizations that consistently reimburse their gambling accounts with non-gambling funds, on the other hand, are essentially paying a portion of their gambling business expenses with non-gambling funds. In our opinion, although reimbursement is required by rule, this practice violates the intent of the law when it is done on a consistent basis because, as mentioned above, statute requires organizations to use *gambling* funds to pay for gambling business expenses. By requiring that gambling expenses be paid with gambling funds, the Legislature implied that charitable gambling operations should be self-sustaining. Among

²³ In calculating organizations' business expenses, we did not account for organizations' reimbursements from their general accounts for cash shortages or overspending of business expenses.

²⁴ We estimated that organizations that exceeded business expense limits by over 25 percent spent \$3.52 to raise a dollar for lawful purposes, while organizations that spent within their limits spent \$.85. Excluding the lawful purpose contributions to state taxes, we estimated that these organizations spent \$7.95 and \$1.58, respectively, to raise a dollar for other lawful purposes.

²⁵ The organization paid taxes and audit fees totaling about \$68,000.

²⁶ The organization paid over \$84,000 in state taxes and regulatory fees and contributed over \$145,000 to "lawful purposes," but we did not have detailed data on fiscal year 2004 charitable contributions to determine how the contributions were distributed.

organizations that showed patterns of overspending, several had reimbursed their gambling accounts from non-gambling funds in fiscal year 2003; in two cases, the reimbursements exceeded \$120,000.²⁷

Finally, consistent overspending of business expenses raises issues of fairness. About 71 percent of the organizations that exceeded their limit by over 25 percent had spending patterns that suggested their overspending was more than an isolated incident.²⁸ Organizations that are able to consistently spend more on business expenses because they have positive balances or other sources of income are able to pay more for compensation, gambling equipment, and other business expenses than other organizations are allowed to spend.

The Gambling Control Board is concerned about excessive gambling business expenses and has worked with the charitable gambling industry and the Legislature to address some of the concerns. For example, in the 2003 and 2004 legislative sessions, the board proposed and the Legislature passed laws to limit rent that bar owners can charge organizations for space, require that rent cover all services provided by the bar owner, and shift the responsibility for cash shortages at bar operations from the organization to the bar owner.²⁹ Possibly reflecting these changes, fiscal year 2004 tax data showed that 449 of the 1,359 organizations that were licensed for the full year overspent their expense limits that year (compared to 592 in fiscal year 2003), with 84 (as opposed to 127) exceeding the limit by over 25 percent. In addition, the board has indicated that its 2005 legislative agenda may propose further changes related to gambling business expenses, including measuring organizations' compliance with expense limits on an annual basis instead of cumulatively and limiting organizations' ability to reimburse gambling accounts using non-gambling funds.³⁰

Recent changes to the law have helped some organizations control their business expenses.

Charitable Contributions

Although charitable gambling has become a significant business, the state's justification for the business has always been to raise money for charities. To that end, the net profits of charitable gambling (receipts less prizes and business expenses) must be spent on "lawful purposes." Very little information is available about how charitable gambling organizations spend their net gambling profits. We reviewed the types of expenses that are considered lawful purposes and analyzed fiscal year 2003 lawful purpose expenditures for a random sample of licensed organizations. We found that:

²⁷ To determine whether overspending in fiscal year 2003 appeared to be an isolated incident or an ongoing practice, we looked at the cumulative expense calculations maintained by the Department of Revenue for fiscal years 2000 through 2002, and for July 2003 through May 2004. We limited this analysis to the 127 organizations that spent over 25 percent over their business expense limits.

²⁸ For about 12 percent of the 127 organizations that exceeded their spending limits by over 25 percent, the overspending in fiscal year 2003 appeared to be an isolated event or spending patterns appeared to be improving. For 17 percent of organizations, we could not discern a pattern.

²⁹ *Laws of Minnesota* (2003), ch. 110, sec. 36 and *Laws of Minnesota* (2004), ch. 172, sec. 6.

³⁰ An October 2004 presentation by board staff to the legislative subcommittee of the Gambling Control Board also included a proposal to limit local investigative fees. Another proposal to count organizations' annual audits as a business expense could make it more difficult for organizations to operate within the business spending limits.

- **Based on estimates of fiscal year 2003 spending, less than half of the \$123 million in charitable gambling net profits (after business expenses) was spent on traditional charities.**

As shown in Table 2.8, state law defines 19 categories of lawful purpose expenditures, some of which are outside the traditional concept of charitable contributions. For example, lawful purpose expenditures include local, state, federal, and real estate taxes; audits; licensing fees; contributions to governments or local-government administered funds; and utilities for certain veterans'

Table 2.8: Lawful Purpose Expenditure Categories

- Any expenditure by or contribution to a 501(c)(3) or festival organization
- Recreational, community, and athletic facilities and activities intended primarily for persons under age 21
- A contribution to the United States, Minnesota or any of its political subdivisions, or any agency or instrumentality thereof, other than a law enforcement or prosecutorial agency
- A contribution to or expenditure on a public or private nonprofit educational institution
- A contribution to relieve the effects of poverty, homelessness, or disability
- An expenditure by a licensed veterans organization for payment of water, fuel for heating, electricity, and sewer costs for a building wholly owned or wholly leased by and used as the primary headquarters of the licensed veterans organization
- Activities that recognize humanitarian or military service to the United States, the state of Minnesota, or a community
- Payment of charitable gambling taxes
- Payment of the reasonable costs of an audit provided the annual audit is filed in a timely manner with the Department of Revenue
- Payment of real estate taxes and assessments on permitted gambling premises wholly owned by the licensed organization paying the taxes, or wholly leased by a licensed veterans organization
- A contribution to a scholarship fund
- A contribution to or expenditure by a nonprofit organization that is a church or body of communicants
- A contribution to a community arts organization, or an expenditure to sponsor arts programs in the community
- A contribution to or expenditure on a wildlife management project that benefits the public
- Expenditure by a licensed veterans organization of up to \$5,000 in a calendar year for meals and other membership events, limited to members and spouses, held in recognition of military service
- Expenditures for grooming and maintaining snowmobile trails and all-terrain vehicle trails or other trails open to public use
- Conducting nutritional programs, food shelves, and group dining programs primarily for persons who are age 62 or older or disabled
- Payment of fees to conduct charitable gambling in Minnesota
- A contribution for treatment of delayed post-traumatic stress syndrome or for the education, prevention, or treatment of compulsive gambling

The 19 "lawful purposes" in statute include some items not typically considered "charitable."

SOURCES: *Minn. Stat.* (2004), §349.12, subd. 25 and Office of the Legislative Auditor.

Taxes consume a large share of organizations' net gambling profits.

organizations.³¹ These other-than-charity lawful purposes consumed millions of dollars in fiscal year 2003. The Gambling Control Board reported about \$123 million in lawful purpose expenditures in fiscal year 2003, including \$56 million in state taxes. Based on our sample of organizations, we estimated that an additional \$10 million went to other non-charity causes.³² As Table 2.9 shows, we estimated that almost \$3 million was spent on utilities at veterans' organizations and about \$7 million was spent on federal, local, and real estate taxes; audits; and licensing fees.³³ In addition, other categories of lawful purpose, such as contributions to (1) government units or funds administered by local governments or (2) registered or accredited educational institutions, may also include contributions to entities other than traditional charities.³⁴ It is not the board's responsibility to ensure that organizations contribute charitable gambling proceeds to charities, only that the proceeds are spent on lawful purposes as defined by the Legislature. However, from a public policy perspective, it is important to understand the extent to which lawful purpose expenditures are made for things outside the common notion of "charity."

We reviewed board policies and procedures to assess the extent to which the board is able to assure that charitable gambling net proceeds are spent on lawful purposes, and we found that:

- **For a variety of reasons, the board is not able to systematically verify that charitable gambling donations comply with state laws.**

Definitions of some lawful purposes are not clear, making compliance difficult.

The Gambling Control Board regularly scrutinizes organizations' charitable contributions, but statutory definitions of lawful purpose categories, the board's reporting requirements and process, and organizations' behavior contribute to the board's difficulty verifying the legitimacy of the contributions.

One factor contributing to the board's difficulty ensuring the legitimacy of charitable contributions is the statutory language defining some lawful purposes. For example, according to the board, the lawful purpose that allows for contributions that honor humanitarian service is vague, leading to questions among organizations and staff about what "humanitarian service" is. Another

³¹ Veterans' organizations that wholly own or wholly lease a building and use it as their primary headquarters may count water, fuel for heating, electricity, and sewer costs as lawful purposes.

³² We selected a random sample of 307 organizations stratified by type of organization (veterans, fraternal, religious, or other) and amount of total lawful purpose expenditures excluding state taxes. The Gambling Control Board provided these organizations' monthly reports of lawful purpose expenditures for fiscal year 2003. The board does not keep electronic data on lawful purpose expenditures. Because we had to create the data from paper documents, we relied upon data for fiscal year 2003. Our estimated lawful purpose expenditures other than state taxes total \$63.5 million, within about 5 percent of the \$67.0 million reported by the Gambling Control Board in its fiscal year 2003 annual report. Minnesota Gambling Control Board, *Annual Report of the Minnesota Gambling Control Board: Fiscal Year 2003*, (Roseville, MN, December 2003), 7. Estimates by type of lawful purpose are complicated by the fact that organizations do not categorize contributions consistently.

³³ The latter figure reflects board fees prior to fee increases that went into effect on July 1, 2003.

³⁴ Local governments can require organizations to make specific expenditures of up to 10 percent of net profits per year, including up to 10 percent of net profits to a fund administered by the city or county. Local governments may distribute the fund to charities, but may also use it for police, fire, and other emergency or public-service related equipment. *Minn. Stat.* (2004), §349.213, subd. 1.

Table 2.9: Estimated Lawful Purpose Expenditures, by Type of Expenditure, FY 2003

	Estimated Amount ^a (in Thousands)	Precision of Estimates (Confidence Interval ^b) (in Thousands)
To or by a 501(c)(3) or festival organization	\$17,219	\$15,500-18,900
Activities or facilities benefiting youth	10,288	9,097-11,500
To a government unit or city or county fund	9,961	8,504-11,400
To a registered or accredited education institution	3,457	2,807-4,108
To relieve poverty, homelessness, disability	3,335	2,680-3,989
Utilities for certain veterans premises	2,856	2,330-3,382
Recognition of humanitarian or military service	2,573	2,231-2,915
Local and federal taxes ^c	2,463	2,078-2,849
Reasonable cost of timely audit or review	2,423	2,145-2,702
Real estate taxes	2,180	1,783-2,577
Scholarship funds	2,175	1,858-2,491
Board approved expenditures	2,039	1,350-2,728
To or by a nonprofit church	1,172	823-1,520
Community arts	325	59-776
Wildlife management projects	275	38-739
Meals and membership events for veterans	270	161-380
Costs related to snowmobile, all-terrain vehicle, or other trails	246	53-487
Food programs for elderly or disabled	161	101-221
Gambling Control Board fees	80	60-100
Treatment of delayed post-traumatic stress syndrome or compulsive gambling	7	2-16

NOTE: Estimated lawful purpose expenditures are based on expenditure reports of a stratified random sample of 307 licensed charitable gambling organizations.

^aThe amounts reported should be considered rough estimates. Due to wide variations in size and number of contributions to the various lawful purposes, the confidence intervals around some of the estimates are large.

^bWe calculated 95 percent confidence intervals. A 95 percent confidence interval means that if samples of the same size were drawn repeatedly from the population and 95 percent confidence intervals were calculated for each sample's estimates, 95 percent of the intervals for each type of expenditure should contain the true contribution amount.

^cState taxes are considered a lawful purpose under this category but are not reported on charitable gambling organizations' contribution forms and are not reflected in this table. The table also does not include state tax refunds for unsold pull-tabs.

SOURCE: Office of the Legislative Auditor analysis of organizations' lawful purpose expenditure reports.

category of lawful purpose that is difficult to verify is expenditures by or contributions to 501(c)(3) organizations.

We attempted to verify the legitimacy of contributions to and by 501(c)(3) organizations because, as Table 2.9 shows, this lawful purpose accounted for the largest share of contributions in fiscal year 2003, and we had concerns about the extent to which the Gambling Control Board was verifying that these contributions comply with law. For 307 sample organizations, we tested whether their contributions in this category met two criteria: (1) that the contributing or recipient organization was tax-exempt under the appropriate section of the

The board relies heavily on paper-intensive reporting.

Internal Revenue Code and (2) that organizations that contributed to themselves spent 30 percent or less of their total expenditures on management, general, and fundraising costs.³⁵ We were unable to verify the contributions' legitimacy in many cases. In some cases, we could not match the reported recipient organizations' names to names in any of the sources we referenced for 501(c)(3) status. In other cases, we could not find information on expenditures, in part because not all 501(c)(3) organizations are required to complete the Internal Revenue Service tax form that includes this information. Our experience attests to the difficulty in verifying the legitimacy of these contributions.

Although we were unable to find information to determine the legitimacy of all of the contributions, some of the information we found suggests that some contributions may have been non-compliant. Among our 307 sample organizations, there were 57 organizations with 501(c)(3) status that made contributions to themselves and for which we could find expenditure information.³⁶ Eleven of the 57 organizations did not meet the second criterion; that is, they spent more than 30 percent of their total expenditures on management, general, and fundraising costs.

Paper-intensive reporting is another factor that makes it difficult for the board to verify contributions. Licensed organizations are required to report their contributions monthly, but the reports are submitted in hardcopy and range from a single line to several pages. The sheer volume of reports limits their usefulness. For example, the board uses the reports to identify potentially problematic contributions, but we estimated that it takes the board over four months, on average, to review one month of reports and resolve issues with organizations.

Variations in how organizations report data and the accuracy of the reports complicate oversight even further. First, the law requires board pre-approval of contributions from one licensed organization to another to prevent organizations from helping each other get around restrictions on uses of gambling funds. We reviewed three years of such contributions. The process seems to work for organizations that seek approval, but the board has found during its reviews of charitable contributions that organizations do not always seek the required approval. Second, organizations do not always keep sufficient or appropriate documentation of their contributions, such as a copy of a recipient organization's Internal Revenue Service letter confirming its 501(c)(3) status. Although the contributions may be legitimate—almost two-thirds of questioned contributions are allowed after organizations provide additional documentation—the process is inefficient. Finally, organizations do not always submit completed reports. When we requested the reports for the organizations we reviewed, the board did not have several reports that tax data suggested it should have. In addition, the board receives reports that are missing required signatures or codes indicating the types of contributions that the organization made.

The sheer volume of reporting limits its usefulness.

³⁵ Minnesota rules contain several other requirements that these contributions must meet. (*Minn. Rules*, ch. 7861.0120, subp. 5(C); <http://www.revisor.leg.state.mn.us/arule/7861/0120.html>; accessed December 2, 2004.) The 30 percent standard in rule applies to the organization's expenditure of the contribution, not total expenditures. But, due to unavailability of data on how particular contributions are spent, the board uses total expenditures as a proxy, and we did the same.

³⁶ Due to the different ways organizations complete their reports of charitable contributions, we may have under-identified 501(c)(3) organizations that made contributions to themselves.

CONCLUSIONS

The board has taken steps to improve its regulation of charitable gambling but needs to use its limited resources more effectively.

The Gambling Control Board has worked hard to mitigate the risks to charitable gambling. For example, within resource constraints, the board has increased the number of compliance reviews and investigations it does each year. However, we think the board could better use its resources to ensure the integrity of charitable gambling. For example, the board has not regularly targeted its compliance resources to problem organizations. In this regard, the board's computer hardware and software, and to some extent staff expertise, have limited its ability to access and analyze data and use them to their greatest advantage. The board also does not have the capacity for organizations to file reports or apply for licenses electronically, resulting in paper-intensive and inefficient board processes.

Regulating licensed organizations' expenditures—for business expenses and charitable donations—is particularly challenging. Although the Legislature has set limits on charitable gambling business expenses, the board's approach to compliance complicates regulation and can result in organizations spending excessively on gambling business expenses. The board's ability to ensure that lawful purpose contributions comply with state laws is hampered by vague and complicated laws; voluminous paper reporting; and the failure of some organizations to follow appropriate procedures, submit complete reports, and maintain adequate documentation. In addition, statutory categories of lawful purposes include items such as taxes and audit fees, making it difficult to know how much charitable gambling money is actually going to charities.

The Gambling Control Board's resources are insufficient to regulate charitable gambling to the same degree as other forms of gambling in the state. We doubt that the board's resources will be increased significantly in the future, so the board must use its resources more effectively. The board needs to invest in technology and target its limited resources to areas of greatest risk, two approaches that the board is pursuing. But perhaps more importantly, we also think this is a good time for the Legislature to critically assess the purpose of charitable gambling and the outcomes that its regulation should achieve, which in turn, will help define what the scope and focus of the board's authority and activities should be.

RECOMMENDATIONS

Improve Licensing

RECOMMENDATIONS

To fully comply with statutory licensing criteria, the Gambling Control Board should:

- *At initial licensure and periodically thereafter, expand background checks of gambling managers to include their criminal records outside Minnesota and*
- *Conduct background checks on all individuals whose positions within an organization make their criminal history grounds for denying an organization license.*

As directed by statute, the Gambling Control Board should develop standards for the percentage of total expenditures that licensed 501(c)(3) organizations may spend on administration and operation.

Licensing allows the Gambling Control Board to limit who can manage and be responsible for charitable gambling operations. Through the licensing criteria it established, the Legislature identified several requirements that organizations and individuals must meet before being given the privilege of a license to conduct charitable gambling. By not applying the licensing criteria in statute, the board is not keeping as tight a rein on licenses as it should.

Several types of criminal convictions, including theft, assault, and fraud, are grounds for denying a gambling manager license or for denying an organization's license if key personnel have disqualifying criminal histories. The board acknowledges that it does not require complete criminal history checks of license applicants, but also points out that the impact of these lapses on the integrity of charitable gambling is unknown and may be small.

Also, state law requires the Gambling Control Board to establish expenditure standards for licensed 501(c)(3) organizations.³⁷ By requiring these standards to be applied to all licensed 501(c)(3) organizations, we believe that the law effectively creates an additional licensing criterion for 501(c)(3) organizations. The board's director agrees that the board has not created a standard that is required by law, but disagrees that the standard should be applied at licensure.

³⁷ *Minn. Stat.* (2004), §349.154, subd. 1.

Increase and Focus Compliance Presence

RECOMMENDATIONS

To better detect and deter noncompliant charitable gambling activities, the Gambling Control Board should:

- *Increase charitable gambling education opportunities, to the extent possible;*
- *Create education requirements for gambling organizations' chief executive officers;*
- *Use its citation authority more frequently in instances of organization noncompliance;*
- *Continue to strive for consistency in issuing citations;*
- *Target some of its compliance reviews to organizations that show signs of problems; and*
- *Increase the use of site inspections, to the extent possible.*

Under the board's current resource constraints, it is critical that the board use its resources and authority as effectively as possible. Increased educational opportunities and requirements should help prevent organization noncompliance. If the board issues citations consistently and often and problem organizations are targeted, organizations that are unable to conduct charitable gambling in compliance with state requirements will either improve or face stronger consequences. Over time, these actions, along with increased site inspections, should help ensure that licensed organizations have the capacity to operate charitable gambling.

We agree with the board that it needs to increase the number of continuing education classes it teaches and create education requirements for chief executive officers (CEOs). In our opinion, the CEO education should focus on how CEOs can help ensure the integrity of their charitable gambling operations through increasing member involvement, establishing gambling or audit committees, and taking other steps to increase oversight. However, we recognize that the board is facing resource constraints. By law, the board may authorize outside staff to provide training.³⁸ Staff from the departments of Public Safety and Revenue have taught classes on illegal gambling and gambling tax forms, respectively, but board staff teach all other classes. The board's director is not confident that others will provide charitable gambling training in a fair and balanced way. We agree that training needs to be accurate and thorough, but identifying individuals who can provide high quality training may be worth exploring as a way for the board to increase the availability of classes and training requirements without adding significantly to the board's workload.

³⁸ *Minn. Stat.* (2004), §349.167, subd. 4.

The board agrees that it may not be using its citation authority as effectively as it could. According to the director, because of the resources that can be consumed during appeals, the board is focusing citations on organizations with repeat violations. We encourage the board to continue this effort. We also encourage the board to critically examine the nature of different violations to determine if more of them warrant citations for first offenses. Citations for one-time offenses are not out of line with current board practice.

It is also important for the board to better target its compliance reviews and site inspections. While the board may still want to review some organizations on a rotating basis, the board should use tax return and other available data to identify organizations that show signs of noncompliance and conduct some of its compliance reviews on these organizations. Because some compliance problems can best be identified through direct observation, the board should also, to the extent possible, increase its use of site inspections. We believe that more effective use of compliance resources in these areas will help the board detect violations and, in turn, allow the board to target its education and mentoring efforts to organizations and issues that most need attention. The board's new strategic operation plan includes both targeting problem organizations and increasing site inspections among the board's objectives.

Improve Technology

RECOMMENDATION

To improve the efficiency and effectiveness of its regulatory activities, the Gambling Control Board should improve its technology to facilitate access to data, quantitative analysis, and online licensing and reporting.

Regardless of the regulatory approach adopted by the board, improved and updated technology is critical to the board's ability to do its job efficiently and effectively. The ability to electronically access and analyze tax return and inventory data maintained by the Department of Revenue and board data on organizations' charitable contributions will help the board identify trends in the charitable gambling industry and problems at individual organizations. The board recognizes the value of these data and analyzes them on an ad hoc basis. But the ability to do routine analyses—and to develop complete profiles of licensed organizations—would be an improvement.

The board agrees that it needs to enhance its information systems and has developed a plan to do so. According to the board's director, the board plans to use its fiscal year 2004 carry forward money for a new system that will allow, among other things, gambling organizations to submit online license applications and reports. The board is still determining the ultimate form the system will take and the best approach for incorporating Department of Revenue data.

Improve Regulation of Gambling Proceeds

RECOMMENDATIONS

To improve oversight of gambling proceeds, the Legislature should consider amending statutes to clarify (1) the applicable timeframe for gambling business spending limits and (2) the extent to which organizations can use non-gambling funds to support their gambling operations.

To help organizations comply with the law and to ease board regulation, the Gambling Control Board should identify lawful purpose definitions that need to be clarified and submit statutory changes to the Legislature.

By establishing business spending limits and requiring that gambling business expenses be paid from gambling proceeds, the Legislature implied that charitable gambling proceeds should support charities and charitable gambling operations should be self-sustaining. However, the board determines organizations' compliance with business spending limits in such a way that organizations (1) can spend over the limits annually and (2) are required to pay for excess business costs with non-gambling revenue. The board should ask the Legislature whether these outcomes are consistent with its intent and to clarify the statute if they are not. The board is concerned that some organizations consistently incur business expenses in excess of limits and is considering how to address the problem in its 2005 legislative agenda.

Statutory definitions of some lawful purposes make it difficult for (1) organizations to comply with the law and (2) the board to verify the legitimacy of contributions. The board is including suggested amendments to some problematic lawful purpose definitions among its legislative initiatives. However, contributions to or by 501(c)(3) organizations are not among the board's initiatives. Given the amount of money contributed by organizations under this category of lawful purpose, the board should consider whether changes to the law would make it easier for the board to verify the legitimacy of the contributions.

Reassess the Board's Regulatory Responsibilities

RECOMMENDATION

The Legislature should reconsider the scope and focus of the Gambling Control Board's responsibilities in regulating charitable gambling.

While the previous recommendations are intended to help the Gambling Control Board work more effectively to fulfill its current responsibilities, we think the Legislature should also reconsider the scope of what the board is currently required to do. There are many options for the Legislature to consider; we present three.

First, the Legislature could change the state's approach to regulating charitable gambling by focusing statutory requirements for the use of charitable gambling proceeds on the percentage of money going to charities, instead of the percentage spent on business expenses. Under this model, organizations would be required to contribute a minimum percentage of their gross profits (gambling receipts after prizes are paid) for charitable purposes, and compliance would be monitored using tax data supplemented with spot-audits to ensure that actual contributions reflect those reported. This could reduce both organizations' reporting burden and the level of detailed compliance review currently required of the board.

Second, or additionally, the Legislature could reduce the state's regulation of charitable gambling conducted by unlicensed organizations. The board would regulate only licensed, nonprofit organizations that have ongoing gambling operations. The board would no longer be required to issue permits for activities held by unlicensed organizations or receive reports from them. Because unlicensed organizations would receive no board scrutiny under this approach, the Legislature might want to reconsider the level of charitable gambling that organizations could conduct without a license.

Finally, the Legislature could strengthen the role of licensing as a regulatory tool. The Legislature could raise the bar for obtaining organization and gambling manager licenses by tightening licensing criteria. For example, the Legislature could require an organization seeking a license to demonstrate that it has sufficient capability to operate and monitor gambling operations. By more tightly controlling who can participate in charitable gambling, noncompliant and illegal activity—and the compliance resources needed to address it—may be reduced.

Minnesota Racing Commission

SUMMARY

The Minnesota Racing Commission provides thorough and multi-layered oversight of horse racing but needs to do more to effectively oversee card club activities. The commission, through its stewards, veterinarians, barn technicians, investigators, and other staff, adequately protects the integrity of horse racing in the state. In contrast, the commission relies heavily on Canterbury Park to oversee card club activities. The commission uses significant resources to license personnel associated with the racetrack and card club. However, due to timing delays inherent in processing fingerprint information, ineligible applicants can be licensed for as much as six weeks before complete criminal history information is available. Finally, the commission would benefit from increased use of technology and should take a more active role in reviewing Canterbury Park's purse allocations and the card club's players' pool.

The Racing Commission regulates horse racing and the card club at Canterbury Park.

The Minnesota Racing Commission, a nine-member citizen board supported by seven staff members, oversees all horse racing in the state and any card clubs that are located at Minnesota racetracks. Currently, Canterbury Park in Shakopee is the only state-authorized card club and pari-mutuel racetrack in Minnesota. Overseeing horse racing and card club activities includes ensuring that (1) only eligible applicants are licensed; (2) races are conducted fairly and in accordance with statutes and rules; (3) the card club operates according to the card club plan of operations;¹ and (4) proceeds from horse racing and the card club are distributed properly to racing purses, breeders' fund awards, and taxes.

To examine how well the commission oversees racing and card club activities, this chapter addresses the following questions:

- **To what extent does the Racing Commission ensure the integrity of horse racing and card club activities?**
- **To what extent does the Racing Commission ensure that proceeds from horse racing and card club activities are allocated correctly?**

To answer these questions, we interviewed Racing Commission members and staff and Canterbury Park personnel; reviewed Minnesota statutes and rules; examined Canterbury Park surveillance, security, and financial documents;

¹ As required by statutes, the Canterbury Park card club's plan of operation governs card club operations.

evaluated commission procedures, documents, and databases; and attended commission and subcommittee meetings.

This chapter is divided into two sections: game integrity and allocation of racing and card club proceeds. The discussion of game integrity focuses on three primary areas—licensing, which relates to both horse racing and card club oversight; responsibilities specific to horse racing; and oversight specific to the card club. The chapter ends with our overall conclusions and recommendations for improvement.

GAME INTEGRITY

Minnesota statutes empower the Racing Commission to “take all necessary steps to ensure the integrity of racing in Minnesota.”² This includes licensing personnel associated with the racetrack, enforcing all laws and rules governing horse racing, and conducting necessary investigations and inquiries.³ Protecting the integrity of horse racing also includes overseeing card club activities. As Minnesota statutes state: “Card club activities are deemed to be relevant to the integrity of horse racing activities in Minnesota.”⁴

Licensing

In effect, licensing is the “gateway” to the racetrack and card club. Licensing is the means by which the commission controls who has access to the racetrack’s “backside” (the stables, barns, practice areas, and dormitories at the racetrack) during the 17-week racing season, and who can work at Canterbury Park.⁵ By law, the Racing Commission screens and licenses all personnel working at and for the racetrack, including jockeys, owners, trainers, grooms, card club dealers, chip runners, vendor employees, and others.

Statutes require that all licensees: (1) not have a felony conviction of record or felony charges pending; (2) are not and never have been connected with an illegal business; (3) have never been found guilty of fraud or misrepresentation in connection with racing or breeding; (4) have never been found guilty of a violation of law or rule relating to horse racing, pari-mutuel betting, or any other form of gambling; and (5) have never knowingly violated a rule or order of the commission or a law of Minnesota relating to racing.⁶

The Racing Commission licenses all personnel that work at or for Canterbury Park.

² *Minn. Stat.* (2004), §240.03 (9).

³ *Minn. Stat.* (2004), §240.03.

⁴ *Minn. Stat.* (2004), §240.30, subd. 7(b).

⁵ In 2005, Canterbury Park plans to have an 18-week racing season.

⁶ *Minn. Stat.* (2004), §§240.06, subd. 1(d); 240.07, subd. 1(d); and 240.08, subd. 2.

We found that:

- **Racing Commission licensing procedures are designed to ensure that only eligible applicants are licensed. However, timing delays inherent in the system mean that ineligible licensees can work at the racetrack for a substantial portion of the racing season.**

The Racing Commission uses significant resources to ensure that applicants are eligible for licensing and has issued an average of 3,650 licenses each year since fiscal year 2000. Commission staff estimated that they spend 25 percent of their seven staff resources on licensing-related activities, including reviewing applications, obtaining fingerprints, and meeting with applicants. Most applicants with arrest records must meet with the commission's security personnel to discuss the nature and disposition of the arrests.⁷ In addition, applicants with a history of racing-related problems at Canterbury Park or other racetracks must also meet with the commission's security personnel and indicate how past problems have been resolved. We agree with the Racing Commission that it is important to have ongoing oversight of applicants and licensees to ensure that only eligible personnel are employed at Canterbury Park and that rules are being followed.

**The
commission's
security staff
interview most
license applicants
with arrest
records.**

The Racing Commission may give applicants a provisional license to work at Canterbury Park while awaiting the results of criminal history checks, which take approximately six weeks. First-time applicants are required to submit fingerprints to the commission, and returning applicants every five years thereafter.⁸ Applicants are given a provisional license upon submission of their fingerprints, which are subsequently sent to the Federal Bureau of Investigation (FBI). However, it generally takes six weeks for the FBI to return the results of the criminal history check to the commission. Because the racing season is relatively short (17 weeks in 2004), an ineligible person who is provisionally licensed can work at the track for a significant portion of the racing season. The delay in receiving the results of criminal history checks is of particular concern when an applicant applies for a license midway through the racing season, as the FBI information may not be available until the racing season is over and the applicant has already left Canterbury Park. This is also true for dealers or other card club employees who are hired only for short-term special events, such as a two-week poker tournament. In fiscal year 2004, the Racing Commission provisionally licensed 38 people who did not disclose an arrest record but whose FBI checks indicated a criminal history.

In addition to obtaining background checks from the FBI, commission staff conduct an average of 162 investigations each year. A large portion of these investigations focuses on verifying applicants' eligibility for a license. Specifically, in fiscal year 2004, 25 percent of the commission's investigations stemmed from FBI reports indicating a criminal history for applicants who had not disclosed an arrest record on their license applications. As discussed earlier, another 13 percent of the investigations involved meeting with applicants who had disclosed an arrest record on their applications, and 11 percent involved applicant

⁷ Applicants with only "minor" previous infractions, such as one arrest due to driving under the influence of alcohol, do not have to meet with Racing Commission security personnel.

⁸ For license renewals, applicants can submit fingerprints or an affidavit stating that they have submitted fingerprints to one of nine "reciprocity" states in the last five years.

or licensee immigration issues. Most of the remaining investigations relate to current licensees' compliance with commission rules. These investigations include reviewing financial complaints, allegations of drug or alcohol abuse, and incidents of illegal wagering.

Horse Racing

Horse racing is heavily regulated across the country and state regulatory agencies play an accepted role in ensuring its integrity. Regulation includes evaluating the health of horses, monitoring the use of allowed medications, protecting against illegal drug use, and ensuring a fair race. We found that:

- **The Racing Commission provides adequate and multi-layered oversight of horse racing at Canterbury Park.**

Regulatory agencies across the country, including the Minnesota Racing Commission, employ various personnel to oversee racing, including stewards, veterinarians, and barn technicians. Each person has a specific role in ensuring the integrity of horse racing, as discussed below.

Specialized staff, including racing stewards and veterinarians, help the commission protect the integrity of horse racing.

The commission hires three stewards each year who are responsible for ensuring that races are run in accordance with commission rules. In essence, the stewards act as a panel of judges for a variety of issues involving the integrity of horse racing. Among other things, stewards determine the official order of finish in a race, resolve problems that occur on the track during a race, hold hearings to resolve alleged license violations, and issue suspensions and fines for these and other infractions.

Stewards' hearings cover a wide range of issues, and their decisions are rarely appealed. The issues that come before the stewards originate from many sources, including the stewards' own observations of conduct on the racetrack, laboratory test results indicating the use of illegal drugs or unauthorized amounts of medication in a horse, and reports from Canterbury Park security or the commission's investigation personnel regarding violations of commission rules. Between fiscal years 2000 and 2004, the stewards made an average of 90 rulings each racing season. Table 3.1 illustrates the types of infractions the stewards have addressed over the past five fiscal years. Fourteen percent of the rulings regarded people who failed to complete license requirements within an allotted period of time, almost 13 percent regarded horses with elevated or disallowed levels of medication, and over 9 percent regarded applicants who falsified their applications. Between fiscal years 2000 and 2004, only 11 of the 449 stewards' rulings were appealed to a commission appeal panel. The appeal panel, which is composed of three Racing Commissioners, upheld all 11 of the rulings. Given the low number of appeals and the absence of reversals in the last five years, it appears that the stewards make reasonable rulings.

Racing Commission veterinarians help to ensure that the horses scheduled to race are healthy and physically able to run in a race through their pre-race exams, observations of the horses in the paddock, and observations on the track prior to and during each race. For a race to be fair, the horses must be healthy and in the condition "advertised" to the betting public, and pre-race exams help meet this

Table 3.1: Steward Rulings, FY 2000-04

<u>Reason Case Brought Before Stewards</u>	<u>Rulings</u>	<u>Percentage of Total Rulings</u>
Individual failed to obtain a license	63	14.0%
Horse found to have a medication violation	58	12.9
Licensee restored to good standing after complying with stewards' ruling	51	11.4
Licensee demonstrated improper conduct, such as misusing alcohol or participating in altercations	47	10.5
Licensee conducted business in an improper manner, including jockeys failing to fulfill riding obligations and trainers not having horses on the grounds at the required times	47	10.5
Applicant falsified license application	42	9.4
Licensee conducted riding-related infractions, including jockeys allowing a horse to impede other horses during a race and misusing a whip during a race	42	9.4
Licensee possessed unauthorized paraphernalia, including needles, syringes, and electrical devices	21	4.7
License suspended or terminated for a variety of reasons, including not submitting fingerprints and failing to complete a license application	17	3.8
Licensee entered an ineligible horse in a race	11	2.4
Licensee failed to meet financial obligations, including not paying Racing Commission fines or racing-related expenses	9	2.0
Other	<u>41</u>	<u>9.1</u>
Total	449	100.0%

NOTE: "Other" includes a variety of racing-related incidents, including not having a horse in a designated place (such as the paddock barn), employing unlicensed help, and a licensee failing to pass a drug test.

SOURCE: Office of the Legislative Auditor analysis of Minnesota Racing Commission licensing database for fiscal years 2000-04.

Stewards act as a panel of judges to resolve problems related to racing, licensing, and other rule infractions.

Very few horses racing at Canterbury Park have had catastrophic race-related injuries.

goal. These examinations and observations of the horses prior to a race also help the veterinarians minimize the number of race-related horse injuries at Canterbury Park. (Veterinarians are able to disqualify, or "scratch," a horse at any time up to the start of a race.) In the period we reviewed (fiscal years 2000 through 2004), the annual incidence of catastrophic race-related injuries at Canterbury Park was below the accepted range of 0.15 to 0.5 percent of racing starts.⁹ In 2003, only 4 of the 5,254 horses that entered and started a race had a catastrophic race-related

⁹ Generally accepted industry rates of breakdown injuries range from 0.22 to 2.1 percent of horses that entered and started a race. The commission holds itself to a more stringent standard. See J.G. Peloso, DVM, MS; G.D. Mundy, DVM; and N.D. Cohen, VMD, PhD; "Prevalence of, and Factors Associated with, Musculoskeletal Racing Injuries of Thoroughbreds," *JAVMA* 204, no. 4 (February 1994): 620-626.

injury, yielding an incidence rate of 0.076 percent; in 2004, the incidence rate was 0.056 percent.

Commission test barn technicians provide another layer of oversight by ensuring that horses receive the proper amount of allowable medication prior to a race, another component of a “fair” race. The test barn technicians oversee and control the administration of one medication in particular, furosemide (also called Lasix), because it can mask the presence of other drugs in the horse’s system. Specifically, all Lasix medication, syringes, and other supplies are stored in a locked container in the “Lasix Barn,” under the control of the commission’s barn technicians. Each horse that races with Lasix is scheduled to receive the drug four hours prior to the race. Although private veterinarians actually administer the Lasix to the horse, a commission technician accompanies the veterinarian to ensure that the correct horse is receiving the permitted amount of medication. While it is still possible for a veterinarian to administer Lasix outside of these controlled circumstances, post-race drug tests on the winners would likely disclose unauthorized use of the drug.

Drug violations are an industry problem nationwide, and Racing Commission drug testing procedures have detected drug-related violations at Canterbury Park. After each race, horses that finish first, and generally those that finish second, are subject to blood and urine

drug tests.¹⁰ One of the state veterinarians, along with a test barn technician, ensures that the samples follow prescribed chain of custody protocol. In 2004, 2 percent of 1,446 horses tested had positive urine tests for either an unallowed drug or an unauthorized amount of a medication. Trainers of horses that return a positive test can have the sample re-tested at another laboratory. If the sample again yields a positive result, the trainer must go before the stewards. Between fiscal years 2000 and 2004, the stewards ruled on 58 medication violations (13 percent of all hearings in this time period); 3 resulted in 30-day suspensions and 55 resulted in a fine (generally between \$100 and \$300).¹¹



In 2004, 2 percent of horses tested at Canterbury Park had positive tests for either an unallowed drug or an unauthorized amount of a medication.

Finally, Racing Commission investigation and Canterbury Park security personnel have a presence on the backside of the racetrack to help detect and deter problems. Specifically, security personnel patrol the barns to ensure that licensees comply with Canterbury Park’s and the commission’s rules and procedures. In addition, commission investigative staff circulate among the various racing venues

¹⁰ The stewards or commission veterinarians may also request that other horses be tested.

¹¹ Trainers with small first-time medication offenses involving specific medications (phenylbutazone or oxyphenbutazone) generally received warnings and were therefore neither suspended nor fined. These offenses are not included in the 58 medication violation rulings discussed above.

(the backside, paddock, winners' circle, test barn, etc.) to ensure that no unauthorized people are present. Commission staff also work with the stewards to determine if licensees have violated commission rules and conduct spot checks of the jockeys' room, barns, and equipment rooms to ensure that all rules are being followed.

Card Club

The detailed rules governing Canterbury's card club are defined in a commission-approved "plan of operation."

Because the Canterbury Park card club is located at the racetrack and was authorized to help support horse racing, the Minnesota Racing Commission has statutory oversight of it. As outlined in Minnesota statutes, "a racetrack may operate a card club at the racetrack...only if the commission has authorized the licensee to operate a card club operation and the commission has approved the licensee's plan of operation."¹² Statutes also state that the commission may withdraw its authorization for the card club "at any time for a violation of a law or rule governing card club operation."¹³ In addition, the Canterbury Park card club's plan of operation, which governs card club activities, gives the Racing Commission the ability to "deny, suspend, revoke or refuse to renew the Plan of Operation [or] the authorization to conduct a card club" for a variety of reasons, including if Canterbury Park or its management have "engaged in conduct that is contrary to the public health, welfare, or safety or to the integrity of card club activities."¹⁴ Statutes hold the authorized licensee (Canterbury Park) responsible for "conducting and supervising the card games, providing all necessary equipment, services, and personnel, and reimbursing the commission for costs related to card club regulation and enforcement."¹⁵

As evidenced by the legislative history that led to the card club's legal authorization, the state has determined that it is important for the Racing Commission to oversee the card club. However, we found that:

- **The Racing Commission does not adequately oversee Canterbury Park card club activities.**

In overseeing the card club, the Racing Commission relies too heavily on Canterbury's surveillance personnel.

The Racing Commission is overly reliant on Canterbury Park surveillance and does little to independently verify Canterbury Park compliance with the card club's plan of operation.

The Racing Commission relies too heavily upon Canterbury Park surveillance personnel for card club oversight. Commission staff have access to Canterbury Park's surveillance room and records, but do not actively participate in surveillance operations.¹⁶ According to commission staff, they do not regularly oversee surveillance activities during live racing months, although they spend more time on the card club during the winter months. Instead, Canterbury Park surveillance and security staff notify the commission of problems as they arise.

¹² *Minn. Stat.* (2004), §240.30, subd. 1.

¹³ *Ibid.*

¹⁴ Canterbury Park, *Card Club Operations Manual* (Shakopee, MN, 2004), Section C.10.A.

¹⁵ *Minn. Stat.* (2004), §240.30, subd. 2.

¹⁶ The surveillance room is where Canterbury Park surveillance personnel observe card club activities through the use of cameras, video monitors, and video recording devices.

Canterbury Park may not be notifying the commission of all relevant card club incidents involving rule violations, security, cheating, and theft.

The majority of Canterbury Park surveillance activity does not involve incidents that concern the commission. We reviewed Canterbury Park's February and June 2004 surveillance logs and, as detailed in Table 3.2, identified surveillance activities that involved the play of the game, card club oversight, or potential cheating.¹⁷ These included verifying jackpots, resolving pot disputes, ensuring proper collections or chip purchases, and reviewing instances of player or employee theft. For the two months we reviewed, Canterbury Park surveillance was involved in an average of 245 of these types of incidents each month. While at first glance this seemed like a large number of incidents, Canterbury Park officials indicated that there are likely over 1 million card game hands dealt each month. In that context, 245 surveillance incidents a month represent only 0.02 percent of all hands dealt. Commission staff did not think it was necessary for them to be involved with much of this surveillance activity and indicated that they are primarily interested in those incidents involving commission rules, security, cheating, and theft.



The Racing Commission may not be sufficiently aware of all relevant surveillance observations. Commission staff rely on Canterbury surveillance to notify them of incidents that occur, and they are especially interested in those that involve rules, security, cheating, and theft. To determine the extent to which this communication takes place, we reviewed Canterbury Park's surveillance logs for all of fiscal year 2004. We found five non-routine incidents about which commission staff did not remember being notified, but should have been. These five incidents included potential employee theft and dealers violating procedures. According to commission staff, it is possible that Canterbury Park notified them about these incidents, but neither their records nor personal recollections could substantiate whether the communication had taken place. Still, the Racing Commission believes that Canterbury Park staff would notify them of all serious incidents.

The commission does not regularly review card club compliance with the club's approved plan of operation.

In addition to over-relying on Canterbury Park surveillance staff, the Racing Commission does not regularly review card club compliance with the club's plan of operation. For example, commission staff do not routinely observe card club dealers to see if they follow procedures or systematically check that Canterbury Park does not exceed the statutorily set maximum number of card tables. The executive director periodically observes dealers during the winter, but has less time to do so in the summer when live racing occurs. Similarly, commission staff have never analyzed the number or type of surveillance incidents that have occurred since the card club has opened, nor have commission staff systematically

¹⁷ We selected one month to represent surveillance activity during live racing (June) and a second month to represent surveillance activity when there is no live racing (February).

Table 3.2: Canterbury Park Surveillance Activity of Interest to the Racing Commission, February and June 2004

<u>Type of Incident</u>	<u>Incidents</u>	<u>Explanation of Surveillance Staff's Role</u>
Proper Play	265	Verifying that proper play is conducted, including ensuring proper shuffling, verifying the winner of a hand, and verifying that the dealer offered "insurance" to players when appropriate
Proper Payout	58	Ensuring that players are paid the proper amount and resolving pot disputes (when two players both claim they won a hand)
Security	35	Resolving problems with security cameras and recording devices
Rules	32	Identifying instances in which dealers or other employees do not follow commission rules, including handling tips at the card tables and not properly displaying Racing Commission licenses
Chip Purchase	29	Verifying that players receive the proper amount of chips
Rake or Collection	17	Verifying that dealers charged, and patrons paid, the proper fee to play a hand of cards
Currency Transaction Report ^a	13	Monitoring patrons that wager over \$10,000 and ensuring that they report these transactions to the Internal Revenue Service
Illegal Wagers	12	Observing and tracking patrons engaged in suspicious behavior that resembles book making or side wagers
Cards	12	Addressing problems with playing cards, including lost and found cards
Player Theft	8	Investigating claims of missing or stolen chips
Employee Theft	4	Investigating claims of employee theft of chips
Counterfeit and Fraud	2	Investigating incidents of counterfeit currency or check cashing fraud
Other	<u>4</u>	Addressing miscellaneous problems including issues with jockeys and underage patrons
Total	491	

NOTE: The table includes only those activities related to the Racing Commission's regulation of the card club. It excludes other activities, such as patron exclusion from the card club, employee and patron medical problems, and overuse of alcohol by patrons.

^aThe United States Internal Revenue Service (IRS) requires that every cash-in or cash-out transaction involving more than \$10,000 be reported to the IRS through a currency transaction report.

SOURCE: Office of the Legislative Auditor analysis of Canterbury Park surveillance logs for February and June 2004.

Commission staff have limited expertise to identify cheating and improper play in the card room.

reviewed surveillance logs to ensure that they are being notified of all relevant incidents.

Finally, the Racing Commission has not paid sufficient attention to card club activities given the dollar value of gambling conducted in the card club. In 2003, card club activities generated approximately 53 percent of Canterbury Park's gambling revenues, compared with approximately 47 percent from horse racing activities. However, commission staff estimated that only about 20 percent of their time is spent on card club related activities while over 80 percent is spent on racing related activities. Perhaps even more important than allocation of time is staff expertise. Commission staff indicated that they have limited expertise to identify cheating and improper play in the card room.

HORSE RACING AND CARD CLUB PROCEEDS

The allocation of racing and card club revenues is complicated. Table 3.3 provides definitions for many of the terms used when discussing racing and card club revenues. In addition to returning money to bettors in the form of prizes, revenues are allocated to horse race purses, the breeders' fund, the state, and the players' pool. Each of these allocations is described below.

Table 3.3: Racing Commission Terms and Definitions

Breakage	The cents not paid to winning pari-mutuel bettors due to rounding down to the nearest 10 cents
Handle	Total amount wagered at a licensed racetrack on horse racing
Pari-Mutuel	The system of betting on horse races where those with winning bets share in the total amount bet, less deductions required or permitted by law
Purse	The amount of money to be paid the participants of a race
Rake or Collection	The fee that patrons pay to play a hand in the card club
Simulcasting	The televised display, for pari-mutuel wagering purposes, of one or more horse races conducted at another location wherein the televised display occurs simultaneously with the race being televised
Takeout	Total amount bet in all pari-mutuel pools less prizes returned to bettors. That is, the handle minus prizes.
Tote System	The system by which pari-mutuel activity, including selling and cashing of tickets, compiling of wagers, and displaying of pari-mutuel information, is accomplished. The tote provider is the company that calculates and reports this information.

SOURCES: *Minn. Stat.* (2004), §240.01; *Minn. Rules* (2003), ch. 7869.0100; and Office of the Legislative Auditor.

The Racing Commission oversees the complicated allocations of racing and card club revenues.

- **Purse Allocation.** Purses for live racing at Canterbury Park are funded through a variety of sources, including pari-mutuel wagers placed at Canterbury Park on live and simulcast races and the per-hand fee patrons pay to play in the card club (the “collection” or “rake”). By law, 8.4 percent of the handle wagered on live races at Canterbury Park or on simulcast races that are concurrent with live races is allocated to purses.¹⁸ A portion of wagers placed on simulcast races that are not concurrent with live races is also allocated to purses through a complicated formula outlined in statute.¹⁹ Canterbury Park and the horsepersons’ organization agreed to set aside 15 percent of the card club “rake” for purse payments and the breeders’ fund in 2004.²⁰ Statutes require that 90 percent of the agreed upon amount be allocated to purse payments.
- **Breeders’ Fund.** The purpose of the breeders’ fund is to “provide incentive monies to enhance the horse racing industry in the State of Minnesota and to encourage Minnesotans to participate in the racing and breeding industry.”²¹ The breeders’ fund receives 5.5 percent of simulcast takeout, 1 percent of live racing handle, and 10 percent of the set-aside for purses and breeders’ fund from the card club rake.²² While exact percentages vary by breed of horse, breeders’ fund revenues must be allocated to equine research, purse supplements for Minnesota-bred horses, breeders’ and stallion awards, and other financial incentives to encourage the horse breeding industry in Minnesota.²³
- **Pari-Mutuel Tax.** Canterbury Park must pay a 6 percent pari-mutuel tax to the state on takeout in excess of \$12 million.²⁴ In fiscal year 2004, the total pari-mutuel takeout was almost \$16.2 million. Canterbury Park started paying fiscal year 2004 pari-mutuel tax in April and paid the state just over \$260,000. Canterbury Park does not pay taxes on its largest source of revenue—the card club rake—which totaled over \$25 million in fiscal year 2004.
- **Players’ Pool.** The players’ pool is a fund generated from players’ losses at card club casino games tables, such as blackjack and pai gow poker. Canterbury Park can only use the players’ pool for promotions and incentives for card game players.²⁵

¹⁸ *Minn. Stat.* (2004), §240.13, subds. 4-5.

¹⁹ *Ibid.*

²⁰ The horsepersons’ organization is the organization that represents the majority of horsepersons racing the breed of horse involved at the licensee’s facility. *Minn. Stat.* (2004), §240.135(a), requires the set-aside for purse payments and breeders’ fund to be 10 percent of the first \$6 million of rake and 14 percent thereafter. However, the statutes allow the licensee and the horsepersons’ organization to negotiate a different percentage, which they did for 2004.

²¹ Minnesota Racing Commission, *2003 Annual Report* (Shakopee, MN, February 2004), 17.

²² *Minn. Stat.* (2004), §§240.13, subd. 5; 240.135; and 240.15, subd. 1.

²³ *Minn. Stat.* (2004), §§240.15, subd. 6 and 240.18; and *Minn. Rules* (2003 and 2004 Supplement Number 1), chaps. 7895.0110, 7895.0250, 7895.0300, and 7895.0400.

²⁴ Once this \$12 million takeout threshold has been met, Canterbury Park must also pay pari-mutuel tax on any breakage it subsequently receives.

²⁵ *Minn. Stat.* (2004), §240.01, subd. 27.

The Racing Commission has the statutory authority to administer and enforce the allocation of pari-mutuel revenues to purses, administer the breeders' fund, collect and distribute all taxes, and ensure that players' pool revenues are used properly.²⁶ At the very least, we think it is important that the commission actively monitor Canterbury Park's allocation of racing revenues to its various purposes. We found that:

- **For the most part, the Racing Commission has adequate procedures in place to ensure that horse racing and card club proceeds are properly distributed. However, there are some shortcomings in how it exercises its responsibilities.**

The Racing Commission monitors Canterbury Park's revenues to determine when pari-mutuel taxes are due and administers the breeders' fund to ensure that the proper amount is collected and distributed to each breed. However, the commission does not regularly verify that the proper amount of revenue is allocated to purses for live races at Canterbury Park or that players' pool funds are used appropriately.

Racing Commission staff monitor and enforce the proper allocation of revenue to pari-mutuel taxes and also actively administer distribution of revenue to the breeders' fund. Commission staff regularly monitor Canterbury Park revenues to determine when and how much pari-mutuel tax must be paid. To administer breeders' fund distributions, commission staff obtain daily reports containing race-specific wager information for all races (live and simulcast) at Canterbury Park. Staff review these data to determine which type of breed ran in each race, calculate the breeders' fund contributions for each breed of horse, and verify the calculations with data from Canterbury Park. Commission staff also ensure eligibility for and oversee distribution of breeders' fund awards. Every spring, commission staff conduct farm inspections to ensure that Minnesota horses registered as intending to produce offspring (broodmares) actually give birth in Minnesota. Every fall, commission staff determine the distribution of breeders' funds awards, which are based on the percentage of total Minnesota-bred purse money each horse earned.

The commission needs to pay more attention to purse contributions and expenditures from the card club players' pool.

On the other hand, the Racing Commission has not paid sufficient attention to the allocation of revenue to purses. The commission relies on Canterbury Park to ensure that funds are properly allocated to purses for live races held at Canterbury Park. Canterbury Park provides a weekly report to the commission detailing contributions to the "escrow purse fund" account, but commission staff do not review the report or verify that the proper amount is distributed.

The Racing Commission also does not closely monitor Canterbury Park expenditures from the players' pool. We found three Canterbury Park card club promotions in which players' pool money could have been given to non-card playing patrons, a violation of Minnesota statutes. We reviewed all player pool transactions since the inception of the card club and found problems with promotions that were for both racing and card club patrons. In general, these promotions were funded in part by the players' pool and in part by Canterbury

²⁶ *Minn. Stat.* (2004), §§240.03 (3), (4), and (6); 240.13 subd. 5(3); 240.135; 240.18; and 240.30, subd. 7(b).

Neither the commission nor Canterbury Park has required an independent security audit of the pari-mutuel tote system.

Park's general marketing funds. In these promotions, it was possible that non-card playing patrons could receive prizes funded by the players' pool.²⁷ Although Canterbury Park officials often ask the Racing Commission to review upcoming promotions funded by the players' pool, the commission does not require this. In addition, commission staff have never reviewed player pool expenditures to verify that the players' pool funds are used only for card club purposes, even though the commission's responsibility includes ensuring that players' pool funds are properly used.

Finally, neither the Racing Commission nor Canterbury Park has required Autotote, the tote service provider at Canterbury Park, to provide assurances that its systems operate properly. The commission relies on Autotote data for many things, including verifying bettor payout, monitoring Canterbury Park finances (including state pari-mutuel tax due), and breeders' fund allocations. However, neither commission staff nor Canterbury Park has ever received independent assurance that the system is accurate, secure, and reliable. In 2002, Autotote was involved in a scandal in which one of its computer programmers manipulated a ticket on a major horse race. If the fraud had not been discovered, it would have netted over \$3 million to the perpetrators. As a result of this incident, the Illinois Racing Board required a security audit of Autotote's information technology systems as a condition of its 2004 Illinois license. The Illinois Board has not determined its future audit requirements for Autotote, but a board representative anticipates a periodic information systems audit becoming a condition of licensure.



While assessing the extent to which the Racing Commission ensures proper allocation of proceeds, we observed that:

- **The lack of automation for some Racing Commission procedures causes inefficiencies in accounting for and monitoring the distribution of gambling proceeds.**

The Racing Commission relies on too many manual procedures to do its work. Unlike Canterbury Park, which receives an automatic download of pari-mutuel wager information from Autotote, commission staff manually enter all wager information into their systems. For example, to determine the amount of revenue to be allocated to the different breeders' fund accounts, commission staff request a

²⁷ In response to our questions about this, Canterbury Park has already made some changes in how they handle these promotions.

paper report from Canterbury Park, which it generates from automatically downloaded data from Autotote. Commission staff then manually enter the takeout data from the report into the commission's computer system for all of the races at Canterbury Park on a given day. From these data, commission staff calculate the proper breeders' fund contribution amounts. Once the breeders' fund allocations are determined, another commission staff member re-enters the breeders' fund allocations into the commission's breeders' fund database.

CONCLUSIONS

The Racing Commission needs to do a better job balancing its responsibilities for horse racing and the card club. The commission focuses its regulatory resources primarily on racing oversight, and does a good job overseeing racing activities. However, since its inception in 2000, the card club has become an increasingly large presence at Canterbury Park. It makes sense for the Racing Commission to focus more regulatory resources on the card club due to the nature of card club activities, including the use of cash, opportunities for cheating, the lack of automated controls, and the amount of dollars gambled. This will likely require an additional staff person with appropriate card club oversight expertise.

Overall, Racing Commission oversight relies too heavily on relationships with Canterbury Park personnel. Commission staff do not independently oversee card club activities, ensure that the proper amount of revenue is allocated to purses, or monitor players' pool expenditures. While there is no evidence of large-scale problems as a result of this reliance on Canterbury Park, we think that the commission should rely more on systems and automatic procedures to maintain an arms-length distance from the industry it regulates.

Overall, horse racing is well regulated, but the commission needs to improve its oversight of the card club.

RECOMMENDATIONS

Streamline Licensing Procedures

RECOMMENDATION

To ensure that the Racing Commission licenses only eligible applicants, the commission should consider obtaining an electronic fingerprinting system to shorten the turn-around time for receiving criminal history information.

Having the ability to submit electronic fingerprints to the Department of Public Safety and the Federal Bureau of Investigation would reduce the turn-around time for receiving criminal history information from six weeks to approximately three days. With criminal history information in its hands sooner, the commission could better ensure that only eligible applicants are licensed. This would prove especially useful for screening applicants that apply for a license toward the end of the racing season or for short-term assignments during card club tournaments. Racing Commission officials would like to purchase an electronic fingerprint

system, although they worry that the cost is prohibitive. However, the commission may have little choice in the matter. The Department of Public Safety has indicated that it will require electronic submission of fingerprints as of August 2005, so the commission will need to make obtaining an electronic fingerprinting device a priority.

Expand Card Club Oversight

RECOMMENDATIONS

To improve oversight of the card club, the Racing Commission should:

- *Have a trained, knowledgeable, and regular presence in the surveillance room;*
 - *Conduct routine compliance checks of card club activities;*
 - *Regularly review players' pool expenditures; and*
 - *Review all promotions using players' pool funds.*
-

The Racing Commission relies too heavily on Canterbury Park to provide surveillance and other daily oversight of the card club, in part because commission staff do not have the expertise to do so directly. While the commission and Canterbury Park staff have a good working relationship, we found several instances in which the commission may not have been informed of incidents that could affect the integrity of the card club. Conversations with commission staff revealed that they have considered increasing their presence in the card club, but have been reluctant to incur additional costs. Our recommendation to expand card club oversight would likely require the commission to hire an additional staff person, resulting in increased expenses. However, by law, the licensee (in this case, Canterbury Park) is responsible for reimbursing the commission for any costs related to card club regulation and enforcement. As a result, if the commission hired a staff person for card club oversight, Canterbury Park, not the Racing Commission, would bear the cost.

In addition to direct card club oversight, the Racing Commission should provide additional oversight of the card club players' pool. The commission should review all players' pool expenditures and any questionable promotions should be reviewed with the Minnesota Attorney General's Office. In response to our questioning of certain players' pool expenditures, Canterbury Park has already made some changes in how they use the players' pool for promotions that are open to all patrons. As a result of these changes, Canterbury Park's practices better conform to the laws governing the use of the players' pool funds.

Verify Purse Contributions

RECOMMENDATION

To ensure that the proper amount is allocated to horseracing purses, the Racing Commission should conduct periodic reviews of Canterbury Park's purse contributions.

In its annual report, Canterbury Park states that the purse expense is one of its "largest single expense items," totaling over \$7.4 million in 2003.²⁸ However, Racing Commission staff do not verify that Canterbury Park is contributing the proper amount to horseracing purses. As outlined earlier, statutes specify the percentage of total amount wagered that must be allocated to purses and give the commission the authority to enforce the laws governing purse contributions. Using information the commission already receives on a weekly basis, staff should periodically verify that Canterbury Park is contributing the proper amount to purses.

Monitor Autotote Reliability and Improve Technology Use

RECOMMENDATIONS

To ensure that it can comfortably rely on information provided by Autotote, the Racing Commission should require regular and comprehensive audits of Autotote's information systems that meet industry standards for information technology security audits.

To more efficiently use its resources, the Racing Commission should make the necessary investments to automatically download the pari-mutuel wager information from Autotote.

In addition, the Racing Commission should revise its current technology systems so staff do not manually enter the same data into the system more than once.

The Racing Commission relies heavily on Autotote information to monitor Canterbury Park, allocate revenue to the breeders' fund, and determine pari-mutuel tax obligations. However, the commission has never required Autotote to provide assurance that its systems are accurate and reliable. In 2004, as a condition of licensure, the Illinois Racing Board required Autotote to conduct a comprehensive information systems technology audit of its Chicago hub operation, which is the same data hub that serves Canterbury Park. The Minnesota Racing Commission should work with its Illinois counterpart (and others) to require a regular audit of Autotote's information technology systems as a condition for licensure.

²⁸ Canterbury Park Holding Corporation, *2003 Annual Report* (Shakopee, MN, 2004), 18 and 28.

The Racing Commission should also improve its own use of technology. Canterbury Park uses software that enables it to receive daily electronic downloads of the Autotote information. Commission staff manually enter these data into the commission's system to perform some calculations, and then re-enter these calculated data into a different part of the system. The commission could achieve some efficiencies if it better used technology. Commission staff would like to update the commission's technology systems, but do not feel that they have the expertise or funding to implement these improvements.

Minnesota State Lottery

SUMMARY

The Minnesota State Lottery is both the promoter and regulator of lottery games, a situation that could compromise the integrity of the games. However, with its comprehensive security procedures, the Lottery protects the security of both its scratch and online games and ensures that Lottery proceeds are allocated properly. We found two instances in which the Lottery did not fully follow its procedures to ensure scratch game security—not conducting full internal security testing on scratch game tickets and not always receiving timely written documentation from the independent security lab that tests scratch game tickets—but we do not believe that either of these compromised the Lottery’s scratch games. The Lottery has thorough procedures to protect its online games, and we found no evidence that these procedures were not followed. The Lottery relies on very sophisticated information technology systems to keep games secure. As such, the Lottery should have regular information technology security audits to ensure that its technology systems are reliable.

The Lottery both promotes and regulates its games.

Unlike other gambling regulatory agencies in the state, the Lottery acts as both the promoter and regulator of the games it offers to the public. By law, the Lottery sets game rules, advertises and promotes games, and ensures the integrity of its games.¹ This chapter discusses the extent to which the Lottery fulfills its regulatory role by addressing the following questions:²

- **To what extent does the Lottery minimize the opportunity for cheating in its games?**
- **How does the Lottery ensure that proceeds from its games are allocated correctly?**

To evaluate the extent to which the Lottery ensures the security of its games, we reviewed Minnesota statutes, Lottery security policies, and Lottery operations procedures. We also interviewed state and national lottery officials and reviewed the national literature. To assess the Lottery’s compliance with its scratch game security procedures in particular, we reviewed game documentation for 20 of 40 scratch games introduced in fiscal year 2003. We selected fiscal year 2003 because this is the most recent year for which prize payout information would

¹ *Minn. Stat.* (2004), §349A.02, subd. 3.

² In 2004, our office evaluated the Lottery’s promotion of games and general management. See Minnesota Office of the Legislative Auditor, *The Lottery* (St. Paul, 2004).

likely be complete. (Players have one year from the end of a game to claim a payout.) We also analyzed the Lottery’s investigation database that contains information on investigations conducted over the past five fiscal years. Finally, to assess the extent to which Lottery proceeds are properly allocated, we interviewed officials from the Minnesota Lottery and the Minnesota Department of Finance, reviewed budget documents, and reviewed Minnesota statutes.

GAME INTEGRITY

The Lottery has primary responsibility for protecting the integrity of its games. Minnesota statutes empower the director of the Lottery to “take all necessary steps to ensure the integrity of, and public confidence in, the State Lottery.”³ To have secure games, the Lottery must provide physical security of scratch game tickets and online game ticket stock; protect against ticket tampering, such as ticket alteration or “peeking;” ensure that the computer and electronic ticket validation systems are secure; and have mechanisms in place to investigate suspicious or unusual activity. We found that:

- **In general, the Lottery’s procedures protect the integrity of its games.**

We also found that:

- **While the Lottery did not fully implement some of its security procedures, this does not appear to have compromised the integrity of the games.**

While no system is foolproof, the Lottery has comprehensive procedures regarding the operations and security of its games. In this section, we discuss the extent to which these procedures help the Lottery protect the integrity of both scratch and online games. Because the security procedures for these games differ, we discuss scratch and online games separately. We also discuss how the Lottery protects its games by providing information technology systems security, reviewing employee and vendor qualifications, and conducting investigations.

Scratch Games

The Lottery’s procedures to ensure the integrity of scratch games are comprehensive and, when followed, minimize the risk of cheating. As detailed in Table 4.1, Lottery procedures for producing a new scratch game include ensuring that tickets conform to the game design, having secure ticket delivery, conducting internal and external security testing of the tickets, and ensuring secured winning ticket validation.⁴ Based on our review of 20 scratch games launched in fiscal year 2003, the Lottery, for the most part, followed its scratch game security procedures; we found only two exceptions regarding independent and internal security testing.

³ *Minn. Stat.* (2004), §349A.02, subd. 3(7).

⁴ Every scratch game is designed according to a specific prize structure, or game design, which prescribes the number and dollar level of prizes for the game.

Protecting against ticket tampering and properly validating winning tickets are important aspects of maintaining Lottery game integrity.

Table 4.1: Minnesota State Lottery Scratch Game Security Procedures

1. New scratch game designed and ordered	The Lottery designs a new scratch game and submits an order for the tickets to a ticket manufacturer.
2. Minnesota State Lottery approves tickets at production phase	A Lottery official travels to the ticket manufacturer's production site to review and approve the tickets.
3. Ticket manufacturer approves tickets at production phase	The ticket manufacturer reviews the tickets for misprints, smudges, and other errors.
4. Ticket records audited by independent auditor to ensure that they conform to game design ^a	An independent auditor reviews all ticket records for the game to ensure that the proper number of winning tickets are in the game.
5. Lottery approves scratch game tickets	Once the tickets are reviewed and audited, the Lottery approves the tickets for delivery.
6. Tickets shipped to Minnesota on sealed trucks	Scratch game tickets are shipped directly from the ticket manufacturer to the Lottery's warehouse in Eagan, Minnesota on sealed and secured trucks.
7. Computer files shipped to Minnesota	Two computer files containing information on the printed tickets are shipped to the Lottery separate from the scratch game tickets.
8. Sample of tickets sent to independent laboratory for tamper-resistant testing	Scratch game tickets are sent to an independent laboratory to test the physical security of tickets.
9. Sample of tickets sent to Lottery's internal laboratory for tamper-resistant testing	Scratch game tickets are sent to the Lottery's laboratory to test the physical security of tickets.
10. Computer files loaded onto Lottery's system	The Lottery downloads the computer files from the ticket manufacturer onto its own system. Records are checked to ensure that the odds of winning approximate the initial game design. Only security division personnel have access to these files, which are ultimately used to validate winning tickets.
11. Tickets approved and distributed to retailers	Once the internal and independent laboratories approve the tickets and the Lottery verifies the odds of the game, the tickets are distributed to retailers.
12. Retailers activate and sell tickets	When retailers are ready to sell a pack of lottery tickets, they must "activate" the tickets (by scanning an "activate" barcode included with the tickets). This allows the tickets to be sold and redeemed. Only the retailer to which the Lottery sent the tickets can activate the tickets.
13. Winning ticket validation	Winning tickets for under \$600 can be redeemed at any Lottery retailer location. Winning tickets between \$600 and \$30,000 must be redeemed at a Lottery regional office. Winning tickets for over \$30,000 must be redeemed at Lottery headquarters in Roseville, Minnesota.

^aEvery scratch game is designed according to a specific prize structure, which prescribes the number and dollar level of prizes for the game.

For the most part, the Lottery follows its scratch game security procedures.

Independent security testing reports for some scratch games were not timely.

- **Game design.** An independent accounting firm audited all 20 scratch games we reviewed, and all were found to conform to the game design created by the Lottery. In addition, Lottery officials reviewed the ticket records for each game when they were loaded onto the Lottery's information technology system and ensured that the game's overall odds and odds at each prize level approximated the original game design. Lottery officials also checked that the number of tickets with the game's top prize was the number specified in the game design.
- **Ticket delivery.** The 20 scratch games we reviewed all had documentation illustrating that the scratch tickets were shipped on secure and sealed trucks and that the Lottery's security procedures were followed.
- **Independent laboratory security testing.** Test results from the independent laboratory for half of the games we reviewed were not reported to the Lottery until after the games' start dates. For two of the games reviewed, results of the independent security test were not provided until almost two weeks after the games started. According to Lottery officials however, if a test report is going to be late, representatives from the independent laboratory inform the Lottery of any problems prior to writing the official report if they think the problems could affect the launch of a game. All 20 scratch games we reviewed were subject to thorough security testing by the independent laboratory. For many of the games, the laboratory found plausible threats to the tickets from computer counterfeiting, hand alteration, and techniques to reveal tickets' validation codes. However, representatives from the laboratory noted that many of the problems found were adequately mitigated by the Lottery's computerized validation process and other security measures the Lottery has in place.
- **Internal Lottery security testing.** The Lottery did not fully implement its protocols for internal security testing. The Lottery has the capability to conduct five types of security tests on scratch games in its internal laboratory, and standard practice is to conduct full testing of all games. Only two of these tests were conducted on each of the 20 games we reviewed. However, we do not believe that this impaired the security of the tickets. Scratch game tickets are also subject to a review by the ticket manufacturer and to security testing conducted by an independent laboratory. While the third level of review provided by the Lottery's internal laboratory offers an additional level of comfort, it may not be necessary.
- **Winning ticket validation.** Lottery officials followed all validation procedures for the four games we reviewed with prizes over \$30,000 (the prize threshold for comprehensive ticket validation). Specifically, Lottery officials checked the tickets for physical alterations, verified that the retailer who sold the ticket did not have any problems with that game, electronically validated the ticket by checking it against game control computer files, and verified that the claimant was an eligible player who did not owe any money to the state.

Although the impact is likely minor, the Lottery did not fully implement its internal ticket testing protocols for the games we reviewed.

The Lottery uses several procedures to validate winning scratch game tickets.

Winning tickets under the \$30,000 threshold are not subject to most of these procedures, but must be verified through the Lottery's electronic validation system. Winning tickets between \$600 and \$30,000 must be redeemed at a Lottery regional office. Winners of these tickets must provide identification, which the Lottery uses to ensure that the player does not owe money to the state. Winning tickets for under \$600 can be redeemed at any Lottery retail location. When a player presents a winning ticket to a retailer, the retailer verifies that the ticket looks like a winning ticket, scans the bar code on the ticket, and keys in a set of validation numbers. The system then verifies that the ticket is a valid winning ticket and that it has not already been paid. If the ticket is valid, the retailer pays the bearer of the ticket and the system records the ticket as paid.

Online Games

Similar to scratch games, the Lottery has designed comprehensive security procedures that protect the integrity of online games. As detailed in Table 4.2, the Lottery's online game security procedures include having secured ticket stock, double-recording all online game transactions, conducting random drawings, and electronically validating winning tickets. Most of the online game operations are conducted by GTECH, the Lottery's online games vendor. Based on our observations, interviews, and review of Lottery documents, we found the online game security procedures to be sound and found no evidence that they were not followed.

Most of the Lottery's online game operations are conducted by a private vendor.

- **Ticket stock.** The ticket stock used for Minnesota online games is secure and controlled. Two outside vendors produce the ticket stock that Minnesota uses for its online games. The ticket manufacturers ship the ticket stock directly to GTECH, where it is stored in a secure location and monitored by Lottery camera surveillance. Entry into the room holding the ticket stock requires two card keys. The ticket vendors send a computer file to the Lottery that links each unique ticket number to a specific carton number. GTECH uses the carton number assigned by the ticket vendor to distribute the ticket stock to retailers; only Lottery security officials can link a specific ticket to a specific retailer.
- **Online transactions.** The Lottery adequately deters insiders from creating "winning" tickets by requiring that all online ticket sale transactions be recorded in two information systems—one at the Lottery and one at GTECH. When a player purchases an online game ticket, the retailer enters the transaction into a terminal provided by GTECH. The transactions are transmitted from the terminal to GTECH's main computer system, which records the numbers that were selected for every online ticket purchased at each retailer location. Every 20 to 30 minutes, all of the transactions recorded in the GTECH information system are transmitted to the Lottery and recorded in the Lottery's information system. A person trying to cheat the Lottery after a drawing was held (once the winning numbers were known) would have to enter the "winning" ticket into both information systems.

Table 4.2: Minnesota State Lottery Online Game Security Procedures

1. Ticket stock printed by outside vendors	The ticket stock is produced on special paper, and each ticket is given a unique identification number.
2. Ticket stock shipped to Minnesota's online games vendor (GTECH)	Ticket manufacturers ship the ticket stock directly to GTECH in numbered cartons.
3. Computer file sent to the Lottery with ticket information	The ticket manufacturers send a computer file directly to the Lottery. This file links the unique ticket numbers on the ticket stock to the carton numbers GTECH receives.
4. GTECH distributes ticket stock to retailers	GTECH uses the carton numbers to distribute the ticket stock to retailers.
5. Retailers sell online tickets, and transactions are recorded and transmitted to GTECH	Retailers use the GTECH terminals to conduct all online game transactions. The online games transactions are sent through the terminals to GTECH's main computer system, which records all online transactions.
6. All online games transactions transmitted to the Lottery	Every 20 to 30 minutes, all online games transactions are transmitted from GTECH to the Lottery and recorded in the Lottery's system.
7. GTECH produces daily transaction report for all online games	Each night, GTECH runs a report that summarizes all online games transactions that have occurred that day.
8. Lottery produces daily transaction report for all online games	Each night, the Lottery runs a report that summarizes all online games transactions that have occurred that day.
9. Transaction reports compared to ensure that GTECH and Lottery systems balance	The GTECH and Lottery transaction reports are compared and balanced daily.
10. Drawings conducted by the Minnesota Lottery for Daily 3, Gopher 5, and Northstar Cash	One of two random number generators is randomly selected. An independent auditor authorizes and oversees the Minnesota drawings. A Lottery official conducts the drawings.
11. Drawings conducted by the Multi-State Lottery Association for Powerball and Hot Lotto	The Lottery and GTECH transaction reports for Powerball and Hot Lotto must be balanced prior to the multi-state drawings. A multi-state lottery supervisor, a police officer, and an independent auditor oversee these drawings.
12. Winning ticket validated	Using the ticket's identification number, the Lottery verifies that the winning ticket originated from the proper retailer and electronically validates the ticket.

We found no evidence that online game security procedures were not followed.

SOURCE: Office of the Legislative Auditor.

Online games transactions are recorded on two separate computer systems and are reconciled daily.

Each night, the Lottery runs a report from its computer system summarizing all of the transactions that have happened that day. The Lottery also receives a parallel report from GTECH that summarizes all of the transactions it has recorded for that day. These reports are reconciled daily to ensure that every transaction has been identically recorded in both information technology systems. In the past twelve years, according to a Lottery official, the Lottery and online vendor reports have always balanced.

- **Drawings.** The drawings for Minnesota's online games are secure. For Minnesota-only games (Daily 3, Gopher 5, and Northstar Cash), an independent auditor verifies that ticket sales have stopped for that day's game and authorizes the drawing to occur. Lottery officials, using a computer program, randomly select one of the two on-site random number generators to use for that day's drawing. Using the chosen random number generator, a Lottery official conducts the drawings for Minnesota's online games. The Lottery conducts regular statistical analysis on the winning numbers to verify that the drawings are random.

The Lottery's procedures also help to protect the integrity of the multi-state drawings. Before every multi-state drawing (for Powerball and Hot Lotto), the Lottery compares its transaction report with the report from GTECH. The Multi-State Lottery Association (MUSL) hires an auditor to be present when the reports are compared and certify that the Lottery and GTECH reports balance. In MUSL drawings (which are held in Iowa), the winning numbers are selected from machines using hard rubber balls. The machines and balls are selected randomly for every drawing, and the balls are weighed and x-rayed several times a year. At every Powerball drawing, a MUSL supervisor, an independent auditor, and a police officer are present. According to the Lottery, MUSL performs regular statistical analysis on the winning numbers to verify that the drawings are random. The Minnesota Lottery began conducting its own statistical analysis of the MUSL drawings in 2004 to provide additional oversight.

The Lottery uses statistical analysis to verify that online drawings are random.

- **Ticket Validation.** The Lottery has adequate ticket validation procedures in place to ensure that only valid winning tickets are paid. Because every online transaction is recorded as it occurs, once the drawing is complete the Lottery knows if there are winning tickets. When a winning ticket is redeemed, an important piece of the ticket validation procedure is to verify that the winning ticket's ticket stock came from the correct retailer. In addition, the Lottery uses an algorithm, involving the ticket serial number and other ticket information, to validate winning tickets.

Information Technology Systems Security

In addition to the game-specific procedures outlined above, the Lottery has other layers of security oversight that help to protect the integrity of all its games. Because the Lottery relies heavily on its information technology systems, access to the Lottery's information systems is password-controlled and must be approved by the Lottery's security department. The security department receives daily reports of Lottery employees' computer activity, which provide the department

Through fiscal year 2004, the Lottery's information technology systems had not been subject to a comprehensive security audit.

with information regarding who accessed the computer system and what they did while in the system. The security systems also identify unusual program access, which helps the Lottery to better target investigation resources. The Lottery's security department also monitors several different aspects of GTECH activity. Specifically, the Lottery has camera surveillance at GTECH; it controls employee access to different areas in the GTECH facility; and it receives daily reports of GTECH computer activity, including access to or changes in files.

Through fiscal year 2004, the Lottery's information technology systems had been subject to limited external audits not commensurate with the importance of information technology in maintaining Lottery integrity. The audits provided information on password protection and inventory controls, among other things, but were largely focused on information systems relevant to the Lottery's annual financial audit. Starting in fiscal year 2005, the Lottery plans to have a more comprehensive annual audit of its information technology systems.

In addition to the Lottery's own information technology systems audit, MUSL conducts a compliance review of the Minnesota Lottery every two years that measures the Lottery's performance against the MUSL standards. Minnesota had its last compliance review in January 2003 and had a record-low number of findings, all of which were corrected. In addition, MUSL indicated that the Minnesota Lottery has enacted good procedures and policies to ensure that its security department has adequate oversight of its internal information technology staff.

Investigations

Lottery security investigations are of two types: (1) background reviews regarding employee and vendor qualifications and (2) investigations of suspicious activity. To regulate who can be associated with the Lottery, all Lottery employees and retailers must undergo criminal history checks. Minnesota statutes prohibit any person who, in the last five years, has been convicted of a felony or a crime involving fraud from being employed at the Lottery or from being a Lottery retailer.⁵ Lottery employees cannot ever have been convicted of a gambling-related offense, and retailers cannot have been convicted of a gambling-related offense within the previous five years. In addition, Lottery retailers must not owe more than \$500 in delinquent state taxes, be in business solely to sell Lottery tickets, or have been convicted of a gross misdemeanor in the last five years. Finally, Lottery retailers must be residents of Minnesota or be authorized to conduct business in the state and cannot be a member of the immediate family residing in the same household as a Lottery employee.⁶

The Lottery does not conduct complete criminal history checks of retailers.

In fiscal year 2003, the Lottery contracted with about 3,100 retailers. For these retailers, the Lottery processed approximately 2,200 retailer renewal applications, 360 new retailer applications, and 140 chain contract renewals.⁷ Retailers must complete a contract renewal every year, and every year the Lottery asks the Department of Public Safety for state criminal history reports on each retailer.

⁵ *Minn. Stat.* (2004), §§349A.02, subd. 6; and 349A.06, subd. 2.

⁶ *Minn. Rules* (2003), ch. 7856.2020.

⁷ A chain contract renewal can apply to several retailers in a chain.

Improvements in Lottery information systems have helped reduce some security problems.

Retailers are not subject to national criminal history checks, which require fingerprints. As a result, the Lottery does not have information on retailers' entire criminal records. In contrast, all Lottery employees and key employees of "major vendors," such as GTECH and the auditing firm, must submit fingerprints for national criminal history checks when they are first hired. Very rarely is a retailer's contract revoked or an employee not hired as a result of a criminal history check.

In addition to reviewing the criminal histories of employees and vendors, the Lottery's security department investigates suspicious activity regarding the play of the game to ensure that only fairly purchased and valid tickets are redeemed. The number of these investigations has dropped by over 50 percent during the last five years. Table 4.3 shows the number and type of Lottery investigations for fiscal years 2000 through 2004. Lottery officials attribute the two largest decreases, in "lockout from lottery computer terminal" and "cashed or attempted to cash a stolen ticket" incidents, to improvements in technology that prevent problems from occurring in the first place.⁸

As Table 4.3 illustrates, there are a large number of investigations regarding lost or stolen tickets every year. Because of the number and type of retailers that sell Lottery tickets, the tickets may be more susceptible to theft than some other types

Table 4.3: Minnesota State Lottery Investigations, FY 2000-04

<u>Reason for Investigation</u>	<u>FY 2000</u>	<u>FY 2001</u>	<u>FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>	<u>Total</u>
Cashed or Attempted to Cash a Previously Redeemed Ticket	393	345	248	240	257	1,483
Lost or Stolen Tickets	366	322	330	245	210	1,473
Lockout From Lottery Computer Terminal	236	246	179	241	21	923
Cashed or Attempted to Cash a Stolen Ticket	234	197	164	71	47	713
Retailer Incident	14	16	21	23	20	94
Altered Tickets	21	15	8	15	10	69
Damaged Tickets	0	1	13	15	8	37
Other	<u>83</u>	<u>45</u>	<u>73</u>	<u>53</u>	<u>76</u>	<u>330</u>
Total	1,347	1,187	1,036	903	649	5,122

NOTES: "Lost or stolen tickets" includes tickets that are lost, stolen by employees, or stolen by customers. "Lockout from lottery computer terminal" is when the terminal that Lottery retailers use to redeem tickets and sell online tickets locks up due to suspicious activity. "Retailer incident" includes player complaints about retailers and retailer license violations and suspensions. "Altered tickets" are instances in which tickets are deliberately altered to look like a winning ticket. "Damaged tickets" are incidents in which tickets are damaged from water, fire, or excessive scratching. "Other" includes incidents involving online games, suspected illegal activity by a retailer, and other miscellaneous incidents.

SOURCE: Office of the Legislative Auditor analysis of Minnesota State Lottery investigation data.

⁸ "Lockout from lottery computer terminal" is when the terminal that Lottery retailers use to redeem tickets and sell online tickets locks up due to suspicious activity; only Lottery officials can unlock the terminal. "Cashed or attempted to cash a stolen ticket" is when a customer redeems, or attempts to redeem, a ticket that has been reported stolen.

of gambling devices. Among the 20 scratch games we reviewed, the number of lost or stolen tickets per game ranged from 785 to over 5,000. On average, for the 20 scratch games we reviewed, about 4 million tickets were printed for each game. For these games, lost or stolen tickets represented less than one-half of one percent of all tickets in a game. The actual threat to the Lottery or its retailers from stolen tickets is limited even further because only “activated” tickets can be redeemed.⁹ Still, according to the Lottery, its security department investigates all reports of lost or stolen tickets. Other investigations may be triggered by repeated efforts by a clerk to validate a non-winning ticket, frequent Lottery winners, and the redemption of old unclaimed winning tickets.

LOTTERY PROCEEDS

The Lottery is responsible for collecting and allocating Lottery revenues. This includes ensuring that tickets are properly purchased, prizes are correctly paid, and profits are distributed to the appropriate state funds. We found that:

- **The Lottery’s procedures adequately ensure that its proceeds are properly collected and distributed.**

The Lottery holds retailers responsible for selling and properly redeeming tickets.

In general, the Lottery holds retailers responsible for selling and properly redeeming tickets. Scratch tickets are generally distributed to retailers on a consignment basis. That is, retailers do not pay the Lottery for the tickets until they are sold. Once an entire pack of tickets is sold, the retailer must settle the pack by scanning the “settle” barcode included with each pack of tickets. Scanning the “settle” barcode triggers the Lottery to bill the retailer for the entire pack of tickets.

Lottery retailers receive a weekly statement from the Lottery detailing all scratch game packs settled at their location, the prizes the retailer redeemed, the number of online tickets sold, and the commission due to the retailer (5.5 percent of tickets sold and 1 percent of prizes redeemed). The Lottery electronically transfers funds from the retailers’ accounts on a weekly basis for the amount due to the Lottery as shown in the statement. If a retailer does not have sufficient funds in its account, the Lottery will follow up with the retailer; persistent insufficient funds will result in a suspended contract. According to Lottery officials, about ten retailers each year have their contracts suspended due to insufficient funds in their accounts.

Retailers are responsible for ensuring that prizes are paid only for valid, winning tickets. If a retailer does not follow the validation procedures and pays an invalid ticket worth over \$25, the retailer will not be reimbursed by the Lottery. This might happen if a retailer only visually inspects a ticket to determine if it is a winner rather than electronically validating the ticket. Similarly, if a retailer does

⁹ When a retailer is ready to open a new pack of tickets and install it in the ticket dispenser, he or she must “activate” the pack by scanning the “activate” barcode included with each pack of tickets. Only the retailer to which the Lottery sent the tickets can activate the tickets. If tickets are reported lost or stolen, the Lottery can “deactivate” the tickets.

not take a redeemed ticket from a player or mark it as paid, and the ticket is redeemed a second time, the first retailer will not be reimbursed by the Lottery.

Because the Lottery is a state agency, distribution of Lottery proceeds to the different state funds is conducted through the state's accounting system. The bulk of the Lottery's funds reside in the State Treasury, and the Lottery works with employees from the departments of Finance, Revenue, Natural Resources, and Human Services to ensure that revenues are properly allocated. Because so many agencies monitor the distribution of Lottery proceeds, there is a low risk of problems.

CONCLUSIONS

Overall, the Lottery has established multiple layers of control that minimize security risks.

The Minnesota Lottery presents a unique challenge for gambling oversight. In essence, the Lottery acts as both the promoter and regulator of its games—a situation that lends itself to compromising the security of the games. If nothing else, the joint role of regulator and promoter gives the appearance of a conflict of interest. However, the Lottery has established several layers of security controls for both scratch and online games that, in our opinion, minimize the risk of security problems.

The Lottery Organization Taskforce met several times during 2004 and plans to recommend that the Legislature establish a lottery board to review the Lottery's operations, annual budget, proposed rules, and general performance, among other things. If the Legislature follows this recommendation, we would suggest that the board also help to ensure that adequate separation remains between the Lottery's regulatory role and its operations and marketing responsibilities.

RECOMMENDATIONS

Ensure Scratch Game Ticket Security

RECOMMENDATIONS

To ensure that scratch games are adequately tested prior to being played, the Minnesota State Lottery should require that the scratch game ticket security test conducted by an independent laboratory be completed and the results reported in writing to the Lottery prior to the launch of the game.

To protect the physical security of scratch game tickets and effectively use its resources, the Minnesota State Lottery should: (1) determine if its internal scratch game ticket testing materially adds to the security of a game, (2) revise its written procedures to be consistent with its assessment of the usefulness of the internal security tests, and (3) follow its written procedures.

The Lottery relies heavily on the results of the ticket security tests conducted by an independent laboratory. As such, the Lottery should obtain the results of this test prior to the distribution and start of a game. If the independent laboratory were to find a problem with a scratch game, the Lottery's reputation and the security of the game would be at greater risk if the tickets were already distributed to retailers around the state. Lottery officials agreed that it is important to receive formal written communication from the laboratory indicating that a game has passed the independent security tests before the game is launched, although they added that ticket printing and distribution schedules create tight timelines for security testing. As a result, Lottery officials will try to have the ticket manufacturer ship tickets directly to the independent laboratory to provide up to a week of extra testing time. In addition, Lottery officials will request that the independent laboratory provide the Lottery with a written summary of its findings prior to launching a scratch game if the full report will not be available prior to the launch date.

Scratch game tickets undergo testing by both the independent laboratory and the ticket manufacturer. However, Lottery officials believe its internal testing is useful because it provides an additional check on the tickets' physical security and also allows Lottery security personnel to keep abreast of ways to compromise tickets. If Lottery officials feel that the internal testing is valuable, they should determine which tests should be performed in the internal laboratory, revise the Lottery's procedures to reflect this decision, and then follow these procedures for all scratch games. Lottery officials agreed with this recommendation, and security personnel plan to undergo training to learn how to conduct the full array of internal security tests.

Ensure Lottery Information Systems Security

RECOMMENDATION

To ensure that it has secure and reliable information technology systems, the Minnesota State Lottery should have regular, comprehensive audits of its information systems that meet industry standards for information technology audits.

Lottery officials have said that the greatest vulnerability to the integrity of the Lottery's games is an "insider" with enough knowledge to manipulate the information technology systems. By having a regular and thorough audit of its information systems, the Lottery can help protect itself against this potential threat. Lottery officials have already taken action on this recommendation. The Lottery plans to have its first comprehensive information technology systems audit in fiscal year 2005 and plans to have a comprehensive technology audit as part of its annual financial audit on an ongoing basis.

Ensure Compliance With Retailer Requirements

RECOMMENDATION

To fully comply with statutes, the Minnesota State Lottery should, when initially entering into a retailer contract and periodically thereafter, expand background checks of retailers to include their criminal records outside of Minnesota.

State law requires that retailers be disqualified from obtaining Lottery contracts if they have been convicted of certain crimes. By only obtaining a retailer's Minnesota (rather than national) criminal history, the Lottery cannot ensure that a prospective retailer complies with these statutory requirements. Hence, the Lottery should request a national criminal history check of all retailers when first entering into a contract, and periodically thereafter. This would be consistent with Racing Commission procedures and parallels our recommendation for the Gambling Control Board.

The Lottery has indicated that, to fully comply with current law, they would need to fingerprint and conduct national criminal history checks of all retailers. In addition, Lottery officials believe that retailers pose significantly less of a threat to gambling integrity in Minnesota than do many of the people licensed by the Gambling Control Board and Racing Commission. Therefore, Lottery officials question whether the cost of conducting national checks is warranted given the minimal threat retailers pose to the security of Lottery games. While we agree that these are reasonable cost-benefit considerations, to continue with its current practice of obtaining a Minnesota-only criminal history of retailers, the Lottery will need to obtain a change in the law.

Alcohol and Gambling Enforcement Division

SUMMARY

The Minnesota Department of Public Safety's Alcohol and Gambling Enforcement Division (AGED) is the only state agency with authority to oversee the state's Indian casinos, although that authority is limited. Overall, the division's inspections of slot machine and blackjack gambling at the state's 18 casinos have not revealed significant compliance problems. However, the division does not make effective use of its inspection authority, so its judgments regarding casino game compliance are based on limited information.

Limitations in the scope of the state's oversight authority and shortcomings in AGED inspections are mitigated by regulation by tribes and the federal government. We recommend that the division fully exercise its inspection authority and expand its casino-related staffing. The division also contributes to oversight of legal gambling by conducting background and criminal investigations, but AGED does not use its investigative resources as strategically as it could. The division could make its background investigation resources go farther by assessing risk and being more flexible in determining the scope and depth of investigations. The division could better target its criminal investigation resources by working with the state's other gambling regulatory agencies to establish criminal investigation priorities and protocols for handing off the right cases at the right time.

The Minnesota Department of Public Safety's Alcohol and Gambling Enforcement Division (AGED) plays multiple roles in the state's regulation of gambling. It implements Minnesota's oversight authority under tribal-state gambling compacts, conducts background investigations of businesses and individuals engaged in the gambling industry, and investigates criminal gambling allegations.

This chapter addresses the following questions:

- **To what extent does the Alcohol and Gambling Enforcement Division effectively exercise its casino oversight authority?**
- **How well does the Alcohol and Gambling Enforcement Division fulfill its roles related to background and criminal investigations?**
- **What opportunities exist to use the division's resources more strategically?**

To answer these questions, we interviewed AGED managers and staff, officials of the other state regulatory agencies that routinely interact with the division, counsel from the Minnesota Attorney General's Office, the U.S. Attorney for Minnesota, and officials from the National Indian Gaming Commission's regional office with jurisdiction over Minnesota. We reviewed tribal-state slot machine and blackjack compacts and associated amendments and observed a casino slot machine inspection. We analyzed available AGED data on casino inspections, background investigations, and criminal investigations. Finally, we visited 5 Indian casinos operated by 4 of Minnesota's 11 tribes.¹ We interviewed tribal leaders, casino managers, and casino regulators to discuss (1) tribes' obligations and actions as primary casino regulators and (2) their opinions regarding the strengths and weaknesses of AGED oversight.

This chapter is divided into two sections. In the first, we discuss the extent of AGED's oversight of Indian casinos; the interaction of federal, state, and tribal oversight; and issues related to compact technical amendments. In the second section, we discuss background and criminal investigations. Recommendations are included at the end of the chapter.

CASINO OVERSIGHT

Minnesota's 11 Indian tribes have primary responsibility to regulate the casinos they operate.

Indian casinos operate in a complicated regulatory environment that involves multiple layers of oversight and a comprehensive set of industry standards designed to protect against cheating, theft, and organized crime. Guidance for how casinos are operated and regulated comes from several sources, including: (1) federal laws and regulations, (2) tribal laws, (3) tribal-state compacts, and (4) tribe-specific policies and procedures. In general, casino oversight involves monitoring compliance with laws, compact terms, and internal control standards. As illustrated in Table 5.1, internal controls are work practices intended to minimize the risk of problems that affect the integrity of casino gambling or loss of casino assets. Internal controls provide both the structure for day-to-day casino operations and criteria for oversight.²

Minnesota's Indian tribes are both the owners of gambling enterprises and their primary regulators. As casino owners, tribes hire casino management teams who are, in turn, responsible for day-to-day operation of the casinos, including implementation of internal controls. As regulators, tribes implement oversight policies and procedures to serve as a check on casino management. In some Minnesota tribes, the tribal council serves as the gambling regulatory authority; other tribes have established separate regulatory commissions.

¹ Because they are sovereign nations, our office does not have jurisdiction over Minnesota's Indian tribes. However, four tribes volunteered to participate in our evaluation—the Bois Forte Band of Chippewa, Mille Lacs Band of Ojibwe, Prairie Island Indian Community, and Upper Sioux Community. We visited both of the casinos operated by the Mille Lacs Band of Ojibwe.

² National Indian Gaming Commission regulations (25 *CFR*, Part 542 (2002)) establish minimum internal control standards for Indian casinos, but tribes may apply internal controls that exceed federal requirements.

Table 5.1: Sample Casino Internal Control Standards

Internal Control Category	Sample Standards
Playing Cards	Playing cards shall be maintained in a secure location to prevent unauthorized access and to reduce the possibility of tampering.
Chip and Token Standards	The tribal gaming regulatory authority, or the gaming operation as approved by the tribal gaming regulatory authority, shall establish and the gaming operation shall comply with procedures for the receipt, inventory, storage, and destruction of gaming chips and tokens.
Blackjack Supervision	Pit supervisory personnel (with authority equal to or greater than those being supervised) shall provide supervision of all table games.
Slot Machine Jackpot Payouts and Fills	For jackpot payouts and gaming machine fills, documentation shall include the following information: (1) date and time; (2) machine number; (3) dollar amount of cash payout or gaming machine fill; and (4) signatures of at least two employees verifying and witnessing the payout or gaming machine fill.
Slot Machine Auditing and Accounting	For online gaming machine monitoring systems, procedures shall be performed at least monthly to verify that the system is transmitting and receiving data from the gaming machines properly and to verify the continuing accuracy of the coin-in meter readings as recorded in the gaming machine statistical report.

SOURCE: National Indian Gaming Commission, Minimum Internal Control Standards, 25 CFR, Part 542 (2002).

States are secondary regulators of Indian casinos, with the terms of the state role established in tribal-state compacts. Minnesota's compacts designate the Department of Public Safety as the state oversight authority. Within the Department of Public Safety, the state's responsibilities are assigned to AGED. These responsibilities include: (1) inspecting casinos for compliance with compact terms, (2) negotiating technical amendments to the compacts,³ and (3) conducting criminal history checks on casino employees and applicants. Our evaluation focused primarily on how AGED has used its inspection authority.

The primary purpose of state oversight is to verify compliance with tribal-state gambling compacts.

State Casino Inspections

Casino inspections are the primary means through which the state directly observes casino operations. The state's oversight authority is bound by Minnesota's tribal-state compacts, which are limited to certain aspects of slot machine and blackjack gambling.⁴ However, the compacts allow a fairly broad range of inspection activity. For example, the video slot machine compact grants the following inspection authority:

³ Only certain sections of the compacts are subject to technical amendment.

⁴ The state does not, for example, have authority over casino hospitality operations, bingo or pull-tab gambling, or most casinowide management practices.

The tribal-state compacts allow the state's Alcohol and Gambling Enforcement Division (AGED) access to a broad array of information for its inspections of slot machine and blackjack gambling.

Agents of the Department of Public Safety of the State of Minnesota ... shall have the right to gain access, without notice during normal business hours, to all premises used for the operation of video games of chance, or the storage of video games of chance or equipment related thereto, and may inspect all premises, equipment, records, documents, or items related to the operation of video games of chance in order to verify compliance with the provisions of this compact.⁵

The state has parallel rights of inspection relative to blackjack equipment and the play of blackjack games.⁶

In addition to requiring independent testing of all slot machines acquired by Minnesota tribes, the compacts specify rules of play for video slot machines and blackjack, which serve as criteria for AGED inspections. For video slot machines, the compact spells out hardware requirements (for example, the computer component that controls game play must be secured using specified procedures) and software requirements (for example, the minimum and maximum payout percentages for different types of games). Similarly, the blackjack compact establishes staffing and surveillance requirements along with rules of game play, including procedures for shuffling, dealing, and wagering.

Because site inspections are the primary means through which AGED conducts its compact compliance activities, our work focused on how AGED conducts inspections and what they have revealed. We found that:

- **Overall, state inspections have not revealed significant compliance problems at Minnesota casinos.**

However:

- **The Alcohol and Gambling Enforcement Division does not make effective use of its inspection authority, so its judgments regarding compliance and game integrity are based on limited information.**

Over the past five years, AGED's casino oversight activity has focused primarily on inspecting individual slot machines. These inspections revealed few problems that affected game play or payouts to winners. But, given the extent of AGED's inspection authority, the division's focus on individual slot machines is too narrow. Overall, AGED's approach to casino inspections does not result in well-justified, documented decisions regarding compact compliance.

AGED Casino Inspections

AGED agents inspect casinos relatively infrequently. According to AGED officials, the division's goal is to visit each casino four times per year, but they have not met this goal. As shown in Table 5.2, AGED makes, on average, about

⁵ *Tribal-State Compact for Control of Class III Video Games of Chance*, Section 4.4; <http://www.dps.state.mn.us/alcgamb/gamslcmp.html>; accessed August 24, 2004.

⁶ *Tribal-State Compact for Control of Class III Blackjack*; Section 4.4; <http://www.dps.state.mn.us/alcgamb/gambjcom.html>; accessed August 24, 2004.

Table 5.2: Casino Site Inspections by Minnesota State Gambling Enforcement Agents, FY 2000-04

Tribe and Casino	Number of Site Inspections					Total
	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	
Bois Forte Band of Chippewa Fortune Bay	3	4	3	3	3	16
Fond du Lac Band of Chippewa Black Bear	4	4	4	4	3	19
Fond du Luth	3	4	3	3	2	15
Grand Portage Band of Chippewa Grand Portage	3	4	3	3	2	15
Leech Lake Band of Ojibwe Northern Lights	4	4	3	2	1	14
Palace	3	4	3	3	1	14
White Oak	n/a ^a	2	2	1	2	7
Lower Sioux Community Jackpot Junction	0	0	3	2	0	5
Mille Lacs Band of Ojibwe Grand Casino Hinckley	2	3	1	1	1	8
Grand Casino Mille Lacs	2	2	2	1	1	8
Prairie Island Indian Community Treasure Island	0	1	0	2	1	4
Red Lake Band of Chippewa Seven Clans – Red Lake	2	1	2	3	2	10
Seven Clans – Thief River Falls	3	4	4	4	1	16
Seven Clans – Warroad	3	4	3	3	2	15
Shakopee Mdewakanton Sioux Community Mystic Lake	1	1	1	2	1	6
Little Six	0	0	0	0	0	0
Upper Sioux Community Prairie's Edge	1	1	2	2	2	8
White Earth Band of Chippewa Shooting Star	<u>3</u>	<u>4</u>	<u>5</u>	<u>3</u>	<u>1</u>	<u>16</u>
All Casinos	37	47	44	42	26	196
Average Number of Site Inspections per Casino	2.2	2.6	2.4	2.3	1.4	10.9

NOTES: According to the Department of Public Safety, department data may undercount the number of site inspections at Jackpot Junction, Treasure Island, Mystic Lake, Little Six, and Prairie's Edge because the department inadvertently destroyed some computerized records for inspections at these casinos. The Upper Sioux Community later provided updated data from its inspection records for the Prairie's Edge Casino, which are reflected in the table.

^aNot applicable because the White Oak Casino opened in fiscal year 2001.

SOURCE: Office of the Legislative Auditor analysis of Alcohol and Gambling Enforcement Division inspection records.

On average, AGED has inspected each casino about twice per year.

two site visits per year per casino.⁷ These site visits—most of which were unannounced—were generally of three types: slot machine inspections, blackjack inspections, or inspections of select internal control procedures, such as those governing access to slot machine keys. Most AGED inspections focus on slot machines, although not every casino received a slot machine inspection every year. In addition, the number of slot machines inspected is a very small proportion of the machines on casino floors. AGED agents generally test three to seven slot machines per inspection. In fiscal year 2004, AGED inspected about 118 of an estimated 20,000 slot machines in operation, or less than 1 percent of the total.



In most inspections, AGED agents identified only minor compliance problems related to slot machine technical standards. AGED agents test for several things when inspecting a slot machine, all of which relate to specific requirements included in the video slot machine compact. They check that: (1) the slot machine's computer and back-up mechanical meters properly record money inserted and paid out,⁸ (2) the casino's computer system properly records when someone opens the slot machine to access its internal compartments, (3) the internal compartment that holds the machine's computer is properly secured, (4) the slot machine's computer program is the correct one, and (5) the slot machine's prize payout percentage is within the compact limits. As shown in Table 5.3, about one quarter of slot machines inspected over the past five fiscal years have been found to be out of compliance with one or more of these requirements. About two-thirds of the noncompliant machines were cited because a mechanical back-up meter failed. According to AGED officials and the slot machine technicians we interviewed, mechanical meters routinely wear out during the course of slot machine play. As a result, maintaining mechanical meters is an ongoing challenge. Most of the remaining compact compliance problems were noted because the casino's computer system did not properly record when the slot machine door was open. This problem usually occurs because of a faulty switch in the slot machine door.

Most inspections focus on slot machine compliance and have identified only minor compliance problems.

Neither problem—mechanical meter or door switch malfunction—directly affects play of the game or proper payout of winnings. According to AGED and tribal

⁷ According to AGED officials, these data may underestimate inspection activity because some inspection records maintained on a laptop computer were inadvertently destroyed. AGED does not have a central, uniform database of casino inspections and results, so it did not have a backup of the lost data. We compiled inspection data from numerous sources: the available computer records, letters to casinos reporting the inspection results, letters from casinos indicating that a compliance problem had been fixed, and other documents provided by AGED.

⁸ Every video slot machine in Minnesota must have mechanical back-up meters. These meters function like the odometer on an automobile. For example, when a coin or bill is inserted into a slot machine, the coin-in meter logs the value of the coins or bill. When credits won are cashed out, the coin-out meter logs the coins taken from the machine.

Table 5.3: Slot Machine Inspection Results, FY 2000-04

	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	Total
Types of Noncompliance						
Mechanical Meter Failed	21	32	23	23	27	126
Monitoring System Did Not Record	5	5	4	11	20	45
Open Slot Machine Door						
Logic Control Compartment Not Secured	6	1	2	0	1	10
Reason Unknown	0	0	5	0	0	5
Other ^a	<u>1</u>	<u>0</u>	<u>1</u>	<u>3</u>	<u>0</u>	<u>5</u>
Total Instances of Noncompliance	33	38	35	37	48	191
Total Slot Machines Inspected	129	166	127	169	118	709
Total Slot Machines With at Least One Instance of Noncompliance	31	37	32	31	42	173
Percentage of Slot Machines Noncompliant	24%	22%	25%	18%	36%	24%

NOTE: An inspected slot machine may have had more than one failure.

^a“Other” includes finding a revoked computer program, inability to test the computer program, and a casino's failure to provide requested information.

SOURCE: Office of the Legislative Auditor analysis of Alcohol and Gambling Enforcement Division information on inspection results.

Neither one of the most common slot machine compliance problems affects game play or payout.

officials, slot machine money-in and money-out activity is recorded in three places: on a casino computer network; in the slot machine's internal, computerized meter; and on the mechanical meter. As a result, in normal circumstances, the casino has two other sources of information regarding slot machine activity if a mechanical meter fails.⁹ Failure of the computer system to record when a slot machine door has been opened affects the casino's ability to monitor unauthorized access to the slot machines. However, casinos have other procedures in place to monitor access to slot machines' internal compartments, including surveillance, a light on top of the slot machine that flashes when the door is open, and monitoring by patrons and employees who work on the casino floor.

Blackjack inspections, though infrequent, have also revealed few problems. For fiscal years 2000-04, about 21 percent of AGED site visits included an inspection of blackjack game play. As with inspections of slot machines, the frequency of blackjack inspections has not been consistent, with some casinos going several years without blackjack reviews. For a blackjack inspection, AGED agents observe game play and check that the proper number of supervisors is present. According to our review of inspection records, over the past five fiscal years, AGED agents identified one instance of game play noncompliance and three instances in which a casino needed an additional supervisor in the blackjack pit.

⁹ Some casino and tribal officials said they would prefer that mechanical meters not be required because they wear out so often. Others, however, thought that a back-up meter not dependent on electricity was useful even with the frequent malfunctioning.

The scope of AGED casino inspections is too narrow.

The division has access to more information than it uses.

Use of Inspection Authority

One of our chief concerns regarding the casino inspection process is that the scope of AGED inspection activities is too narrow, particularly for slot machine gambling. Although the tribal-state compacts allow AGED access to relevant documents and records, AGED has generally limited itself to physical inspections of slot machines. We agree with AGED that it should concentrate its efforts on slot machines because they account for the vast majority of casino gambling activity. However, threats to the integrity of slot machine operations extend beyond the functioning of individual machines, and the division's judgments regarding compact compliance should consider a broader array of information.

Under the compacts, AGED has access to many information sources to make such assessments, including relevant casino information systems, casino financial and internal control audits, compliance data from tribal regulatory authorities, and AGED's own observations and assessment of slot machine play. The tribal officials we interviewed said that their tribes would provide ready access to this information during AGED site visits, but with a few exceptions, AGED has not asked for it.

By not fully using these resources, AGED is not operating as effectively as it could. For example, because slot machines operate on networked computer systems, relying only on tests of individual slot machines is both an inefficient and insufficient way to get an accurate picture of how slot machines are functioning casino-wide. Using the slot machine information system, casinos can easily monitor and analyze data on slot machine play and payout for individual machines *and* for the system as a whole. These systems can generate reports on a daily basis showing payout percentages for every slot machine on the casino floor and can identify slot machines operating outside of expected norms (e.g., an unusual number of coin refills in a day or a payout percentage deviating by more than a few percentage points from the manufacturer's settings).¹⁰ Although AGED uses information system data to some extent when it inspects individual slot machines, the division does not use these data to systematically assess slot machine compliance.

Furthermore, AGED does not pay sufficient attention to other aspects of slot machine and blackjack gambling. At most of the casinos in fiscal year 2002, AGED conducted inspections that focused on select internal controls, such as access to slot machine keys and disposal of old decks of cards. According to the resulting inspection



¹⁰ During our casino visits, tribal officials told us that casino managers, internal auditors, and tribal regulatory authorities obtain and analyze these data continually to assess slot machine operations. Among other uses, for example, officials said casinos on a daily basis reconcile slot machine information system meter data on money inserted and paid out with accounting department data.

reports, AGED found most controls to be sound, but identified some areas at certain casinos where changes needed to be made, including tighter security over access to keys. Tribal officials that we interviewed reported that the internal control inspections were more useful than AGED's normal inspections, but since 2002, AGED has not repeated them. In addition, AGED does not check tribes' compliance with other aspects of the compact, including requirements for background checks and licensing.

Compact Regulatory Standards for Slot Machines

During our evaluation, AGED officials raised concerns that the compact standards are out of date. As discussed earlier, the hardware and software technical requirements in the video slot machine compacts are key criteria for state oversight of slot machine gambling. But, AGED officials said that many of these requirements do not reflect the technology used in slot machines currently being produced because slot machine technology has changed substantially since the compacts were originally signed nearly 15 years ago. As a result, the division believes that the technical standards for new slot machine models are unclear. AGED managers want the Commissioner of Public Safety and tribes to use the technical amendment process to adopt new hardware and software standards that reflect those currently used in the industry.¹¹

The tribal officials we interviewed generally did not see an urgent need for technical amendments. The officials said that before their tribes purchase slot machines built with a new technology, they ensure that an independent laboratory has certified the machines for use in Minnesota and that tribal regulators are trained on how they operate. Tribes said that, as a result, the slot machines they buy comply with the compacts and can be tested to ensure proper functioning. Although tribal officials said they would consider certain technical amendments, they argued that if AGED agents had training on the new technology similar to that of tribal regulators, AGED would have fewer concerns.

Because casinos operate in a shared regulatory environment, it is in the best interests of the state and tribes to reach a mutual understanding on the issues in dispute. Whether agreement is reached through common training, technical amendments, or both is an issue for AGED and tribal leaders to resolve.

Regulation by Tribes and Other Agencies

Because AGED serves in a secondary oversight role, we felt it was important to understand, to the extent possible, how tribes and other oversight authorities ensure the integrity of slot machine and blackjack gambling. According to AGED officials, the division has always relied on an understanding that casino regulation is an interrelated system that crosses many governmental jurisdictions—primarily the tribes, but also the federal Interior, Treasury, and Justice departments, among others. As a result, the impact of limitations in state oversight is balanced by tribal or federal regulatory authority. For example, although AGED does not

¹¹ AGED is concerned, for example, about new slot machines for which substantial game functions are controlled by a computer network server, not a stand-alone computer within the slot machine itself. The current compacts, as amended, are silent regarding regulatory standards for this type of technology.

The state and tribes disagree on whether the compacts' technical standards for slot machines need to be amended.

verify compliance with the compacts' background check and licensing requirements, at the casinos we visited, the National Indian Gaming Commission (NIGC) has assessed compliance with similar federal and tribal requirements. Our work on the effectiveness of other jurisdictions' oversight was limited, but based on our review of the laws and rules governing Indian casino oversight and interviews with tribal, state, and federal regulators, we found that:

- **Regulation of Indian casino gambling by tribes and the federal government mitigates limitations in state oversight authority.**

Taken together, we believe that tribal, state, and federal government agencies provide comprehensive oversight of Indian casinos.

For example, the four tribes that participated in our review had multi-layered controls and regulatory mechanisms in place to protect the integrity of games. Throughout our visits, tribal officials and casino managers emphasized that the integrity of casino gambling rests on designing and implementing strong internal control procedures for all aspects of casino gambling—from receiving a new slot machine on the loading dock to specifying the number and types of employees who must be present when a slot machine is opened. Casino managers have day-to-day responsibility for implementing these procedures, and tribal regulators are responsible for testing and reporting on the procedures' effectiveness.

In addition to enacting industry internal controls, the tribes we visited had also established oversight policies and procedures. For example, two of the four tribes that participated in our study have separate units of tribal government in charge of casino regulation; the other two have compliance officials who report directly to the tribal council. Generally, these gaming regulatory authorities make licensing decisions, monitor and report on casino compliance with policies and procedures, recommend changes to procedures, and have authority to issue directives to casino managers. In some cases, casino surveillance staff work for the regulatory authority rather than for casino management. In addition, some tribes have internal audit departments that scrutinize all tribal-owned businesses. In all cases, tribal officials said that they take compliance seriously.



Minnesota casinos are also subject to other external oversight and reviews that evaluate the effectiveness of tribal oversight. For example, the NIGC, through its regional office in St. Paul, conducts regular site reviews of casino operations. These reviews are generally targeted at one or two specific areas, such as employee background checks or handling of cash. According to NIGC officials, the commission has few concerns regarding Minnesota casino operations and thinks tribal regulation in this state is generally sound. In addition, casinos must have annual, independent financial and internal

Taken together, tribal, state, and federal governments provide comprehensive oversight of Indian casinos.

control compliance audits conducted by certified public accounting firms. Along with oversight by the U.S. Interior and Justice departments, the U.S. Department of the Treasury and the Internal Revenue Service also impose significant regulatory requirements and provide external oversight in their areas of interest, which include reporting of suspicious activity and large cash transactions. Tribal officials told us that the Internal Revenue Service regularly audits their casinos.

INVESTIGATIONS

In addition to overseeing casinos, AGED conducts two distinct types of gambling-related investigations: (1) in-depth background investigations of businesses and certain individuals involved in Minnesota's gambling industries and (2) law enforcement investigations regarding allegations of criminal misconduct.¹² AGED does both types of investigations for its own areas of direct oversight and on behalf of the other state gambling regulatory agencies.

Background Investigations

AGED conducts background investigations of businesses involved in Minnesota's legal gambling industries.

Background investigations provide gambling regulators with detailed information relevant to an applicant's suitability for licensing, including criminal history, regulatory history, and other conduct. By law, AGED conducts background investigations on (1) the manufacturers and distributors of gambling devices that it licenses directly; (2) businesses licensed by or under contract with the other three state regulatory agencies, such as the Lottery's online games vendor and the pari-mutuel "tote" company licensed by the Racing Commission; and (3) certain individuals involved in the conduct or regulation of gambling, such as the directors of the gambling regulatory agencies.¹³ AGED generally conducts about six to eight background investigations each year, most of which are of businesses.

Based on our review of AGED investigation procedures and reports and interviews with AGED investigators and officials from the other regulatory agencies, we found that:

- **AGED background investigations are generally very thorough, but some take too long.**

AGED investigators use a standard approach to conducting background investigations, though each investigation proceeds according to the applicant's circumstances and the issues or concerns that are uncovered. For example, an investigation for a small business owned and operated by one or two individuals will be quite different from an investigation of a multinational corporation. As illustrated in Table 5.4, investigations are generally broad in scope and quite

¹² Background investigations discussed in this section differ materially from the routine criminal history checks referred to in Chapters 2-4. Casinos, the Racing Commission, the Lottery, and the Gambling Control Board routinely request arrest and conviction records, which are considered when making hiring, licensing, and contracting decisions. For these criminal history checks, AGED is an intermediary, forwarding requests to the state's Bureau of Criminal Apprehension and, for national criminal history checks, to the Federal Bureau of Investigation.

¹³ *Minn. Stat.* (2004), §§299L.02 and 299L.07.

Table 5.4: Elements of Background Investigations for Businesses

Process	Description
Obtain license application and background investigation query form and request documents	<p data-bbox="607 369 1455 478">On the application and query form, applicants provide, among other things, information on gambling licenses in other jurisdictions, involvement in allegations of criminal violations related to gambling, banking institutions, and lists of key personnel.</p> <p data-bbox="607 508 1455 558">AGED agents submit a standard document request, which generally includes the following information for the past five years:</p> <ul data-bbox="607 588 1455 1230" style="list-style-type: none"> <li data-bbox="607 588 1455 730">• Financial information, including check registers or disbursement ledgers, a list of wire transfers, cash receipt and disbursement journals, expense or accounts payable journals, year-end general ledgers, fixed asset and expense payable invoices, and a list of all persons with bank account signature authority <li data-bbox="607 760 1455 869">• Business relationship information, including letters of intent, contracts, or other agreements between the business and banking institutions; lease agreements; private placement agreements; and consulting contracts <li data-bbox="607 898 1455 928">• Customer and vendor lists <li data-bbox="607 957 1455 1008">• Corporate minutes, shareholder meeting minutes, and minutes from all internal meetings related to gaming <li data-bbox="607 1037 1455 1066">• Listing and brief description of all litigation pending <li data-bbox="607 1096 1455 1146">• All correspondence, internal memoranda, letters of engagement, management letters, etc., between the business and its audit firms <li data-bbox="607 1176 1455 1230">• Expense reports, corporate credit card statements, and employment contracts for individuals included in the investigation (see below)
Identify individuals who will be investigated and request documents	<p data-bbox="607 1247 1455 1356">Individuals subject to investigation generally include owners or shareholders holding 5 percent or more of the company, board members, the chief executive officer, president, chief operating officer, and chief financial officer (typically six to eight people).</p> <p data-bbox="607 1386 1455 1465">From these individuals, AGED agents collect personal history statements, statements of net worth, state and federal tax returns, personal check registers, bank statements, and fingerprints.</p>
Conduct interviews	<p data-bbox="607 1482 1455 1562">AGED agents conduct personal interviews with individuals being investigated and, as needed, other officers and employees, auditors, attorneys, and federal or state law enforcement and regulatory agency personnel.</p>
As needed, investigate further and make additional document requests	<p data-bbox="607 1579 1455 1638">AGED agents further investigate the business, as needed, through contacts with other gambling or financial regulatory agencies, attorneys, audit firms, etc.</p> <p data-bbox="607 1667 1455 1711">AGED agents request additional documentation if interviews or initial document review reveal areas of concern or previously undisclosed issues.</p>

SOURCE: Office of the Legislative Auditor compilation from Alcohol and Gambling Enforcement Division license application and background investigation documents.

On average, background investigations take about a year to complete, but some have taken considerably longer.

detailed. The investigation steps and information requested at each stage are derived from the licensing criteria established in law for manufacturers and distributors that AGED licenses directly, but the other regulatory agencies apply similar licensing criteria.¹⁴ For example, when deciding whether to grant a license, AGED must assess whether an applicant or one of its key employees makes false statements, has had a gambling-related license revoked in another state, has been convicted of a felony, or has engaged in conduct found to be contrary to the integrity of gambling or that poses a threat to effective regulation. Thus, the background investigation should be structured to support this decisionmaking. According to AGED agents, to thoroughly investigate all aspects of a business (and the six to eight key employees generally included in an investigation) requires sifting through hundreds of documents, including complex financial reports; conducting site visits and interviews; and following up on potential problems.

Background investigations of this nature are time-consuming, but some background investigations have taken too long. On average, an investigation takes about a year to complete, but other investigations have taken significantly longer. For example, the Lottery requested an investigation of its new online game vendor (GTECH) in July 2002 but did not receive the investigation report until March 2004. The background investigation for Autotote, Canterbury Park's pari-mutuel "tote" company, was done in two phases. The original investigation took about a year-and-a-half; the second phase, initiated after another company acquired Autotote, took an additional 10 months. AGED acknowledged that the GTECH investigation took too long because the division did not direct enough attention or resources to the investigation to get it done more quickly. According to AGED, the Autotote investigation took longer because of a variety of complexities, including the Racing Commission's request for additional work, international travel to investigate a new foreign owner, concerns regarding the parent company's involvement in Internet gambling, and conflicts with the Racing Commission regarding the investigation process. One consequence of long investigations is that businesses can work in the gambling industry for extended periods of time without a completed background investigation.

In general, AGED prefers to err on the side of expansive background investigations.

A variety of factors contribute to the length of background investigations, some within and some outside of the division's control. The division's philosophy is to err on the side of expansive background investigations, which contributes to their complexity and length. AGED agents said that they choose to cast a wide net when conducting background investigations because they cannot rely on applicants to self-disclose possible problems. As a result, agents must sift through original documentation and personally conduct interviews. Also, as a matter of policy, AGED agents do not rely on the work of other states' regulatory agencies, although they use the results of other states' investigations as "pointers" for Minnesota's investigation. In general, AGED officials believe that a mistake resulting from a too-narrowly scoped background investigation or reliance on other states' investigations could have serious consequences for the public's trust in the integrity of gambling in Minnesota. While we agree that background investigations should provide a sufficient basis for licensing decisions,

¹⁴ *Minn. Stat.* (2004), §§240.06; 240.07; 240.08; 299L.07; 349A.07; and 349.155. Licensing criteria used by the Gambling Control Board, Racing Commission, and Lottery are discussed in Chapters 2, 3, and 4, respectively.

investigators should exercise reasonable judgment in defining the scope and depth of an investigation.

The duration of an investigation is also influenced by factors outside of AGED's control.

AGED staffing decisions also affect timeliness. For the most part, three special agents conduct background investigations on a part-time basis, balancing background investigations with criminal investigations and other division work. Delays in starting an investigation and diversion of staff during an investigation also contribute to long turnaround times. AGED officials said that background investigations are balanced against other workload needs, and that some investigations were slow to start or were temporarily suspended because agents were needed on higher priority work.

However, the duration of an investigation is also heavily influenced by factors that AGED is less able to control, including: (1) how quickly the applicant and individuals being investigated respond to requests for information, (2) the time it takes to schedule necessary personal interviews, and (3) the extent of new information requests and follow-up required if something unusual surfaces during the investigation. Although the average investigation takes about a year, the direct staff time per investigation averages about 165 hours, or a little over a month. So, much of the investigation's duration can be explained by wait time. AGED could be more aggressive in scheduling the necessary investigation steps and could potentially change its staffing policies, but investigations would likely continue to stretch over several months.

Criminal Investigations

AGED special agents are the state law enforcement officers who investigate illegal gambling and criminal allegations associated with legal gambling. Gambling-related criminal complaints are referred to AGED by the other gambling regulatory agencies or come directly from organizations that conduct gambling, citizens, and other law enforcement offices. Our review focused primarily on criminal investigations related to legal gambling.

AGED does not have the resources to investigate every gambling-related criminal allegation.

As shown in Table 5.5, AGED's criminal caseload has grown over the past five fiscal years. About half of the division's cases are related to illegal gambling, and roughly 30 percent involve charitable gambling crimes. (Most theft-related cases are associated with charitable gambling.) Investigations of crimes related to horse racing, the card club, and casinos are much less prevalent, and AGED does not investigate Lottery-related crimes, such as stolen tickets, because the Lottery generally refers its cases to local law enforcement agencies. Over the past five years, AGED data show that roughly 8 percent of gambling-related cases resulted in arrests.

AGED does not have the resources to investigate every potential criminal gambling case and must balance competing priorities in choosing which cases to pursue. According to AGED, to best use its resources, the division tries to focus on (1) the most serious allegations and (2) those cases with the best chance of prosecution and conviction. For cases referred from the other gambling regulatory agencies, AGED agents like to get involved relatively early to ensure that the investigation proceeds in a manner that protects suspects and supports criminal prosecution.

Table 5.5: Gambling-Related Criminal Investigation Cases Opened, FY 2000-04

	Number of Investigations Opened					Total	Percentage of Total
	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004		
Illegal Gambling	62	80	102	105	103	452	48.4%
Theft or Theft-related ^a	42	35	18	19	35	149	16.0
Charitable Gambling	5	14	33	40	32	124	13.3
Casino	4	9	10	4	6	33	3.5
Card Club	2	7	3	6	3	21	2.2
Horse Racing	0	0	2	1	2	5	0.5
Case Referred to Other Jurisdiction	3	10	6	5	3	27	2.9
Miscellaneous ^b	<u>12</u>	<u>31</u>	<u>26</u>	<u>30</u>	<u>24</u>	<u>123</u>	<u>13.2</u>
Total	130	186	200	210	208	934	100.0%

^aTheft cases are most often related to charitable gambling.

^bOf all miscellaneous cases, about 77 percent were cases in which gambling enforcement agents provided miscellaneous assistance and advice to other agencies, and the remaining 23 percent were divided equally among cases opened to install a surveillance camera and cases involving falsifying or destroying documents (including falsifying license applications).

SOURCE: Office of the Legislative Auditor analysis of Alcohol and Gambling Enforcement Division investigation case data.

We did not evaluate how AGED agents conduct criminal investigations; rather, we assessed how cases are referred to AGED and prioritized. We found that:

- **The process for transferring criminal cases from other gambling regulatory agencies to AGED is not always effective; in some instances, the division is not getting involved early enough in case development or focusing on the highest priority cases.**

The Gambling Control Board and Racing Commission refer criminal cases to AGED, but this hand-off process does not always go smoothly.¹⁵ The issue is particularly relevant to the Gambling Control Board, which makes most of the regulatory agencies' case referrals. Over the past several years, AGED and the Gambling Control Board have disagreed over which cases to hand off and when. According to AGED agents, regulatory agency investigators sometimes held on to cases because they viewed hand-off to AGED as optional. According to the Gambling Control Board, though, board investigators continued to develop possible criminal cases because, once referred, AGED did not work the cases promptly. AGED agrees that it often has a backlog of cases that are not being actively investigated.

Timely involvement of law enforcement officers has important consequences when prosecuting cases. According to AGED officials, the proper time to move a case from the regulator's jurisdiction to criminal jurisdiction is when it has gone far enough to demonstrate criminal activity, but before the case involves investigation steps, such as interviewing suspects, that are important in building a criminal case for court and protecting suspects' rights. An investigation that proceeds according to criminal case standards can later be used as the basis for

¹⁵ The Lottery does not transfer cases to AGED; instead, it works directly with local law enforcement offices and county attorneys.

Timely referral of cases from the Gambling Control Board to AGED has been a problem.

regulatory action, but material learned through civil investigation often cannot be used in criminal prosecutions.

Prioritizing cases for criminal investigation is another ongoing challenge. Because evaluating complaints to determine whether to open an investigation uses AGED staff resources, it is important that other gambling regulatory agencies refer cases that are most likely to lead to investigations. In general, the division wants to focus its criminal investigations on the most serious crimes (that is, possible felony cases should receive a higher priority than misdemeanor cases). According to AGED, the Gambling Control Board refers many lower-level cases that, from a resource perspective, the board should handle. For example, holding a non-permitted or otherwise illegal raffle is a misdemeanor, but it is unlikely that AGED will pursue it as a criminal case. Both AGED and the board would resolve the case in the same way—with a phone call to the organization that held the illegal raffle informing the organization of the law and stating the offense should not be repeated. Hence, illegal raffle cases of this nature should rarely be referred to AGED for evaluation.

AGED and the other gambling regulatory agencies do not have written protocols to guide which criminal cases should receive highest priority.

The Gambling Control Board, Racing Commission, Lottery, and AGED do not have written protocols to guide appropriate transfer of cases to AGED, although historically, the Lottery has referred its criminal cases to local law enforcement offices and county attorneys. Currently, prompt and appropriate case referrals result most often when there is a good relationship between an AGED special agent and an investigator at another agency. Ideally, AGED agents would—across regulatory agencies—like to hear informally about any allegation that looks criminal and then direct the next steps, including which cases to hand off to AGED and when.

Although most AGED agents specialize in certain forms of gambling, they do not regularly work out of the other agencies' offices, which impedes this type of informal, routine communication. AGED staff assignments at Canterbury Park are an exception. AGED assigns staff weekly to monitor the Canterbury Park card club, but their occasional presence does not provide meaningful oversight. AGED agents are assigned on a weeklong, rotating basis. The assigned agent generally visits the card club for several hours, two to three times during the week. The agent looks through the Canterbury Park surveillance logs, may talk with surveillance personnel to get more information on incidents of interest, and occasionally checks in with the Racing Commission. However, agents have varying levels of interest and expertise in card club operations, contributing to an inconsistent AGED oversight presence. In addition, the nature of the oversight—relatively short and sporadic periods of time during a week—make it difficult for AGED agents to provide meaningful oversight. For example, Racing Commission and Canterbury Park surveillance personnel believe that AGED agents systematically review surveillance logs for recurring problems and trends. In reality, the extent of analysis of these logs depends on which agent is assigned to the card club that week. In our opinion, AGED's presence at the card club could be useful. However, the division needs to assign the responsibility primarily to one or two agents (rather than rotating it among all special agents), and those agents need to have a more substantive presence at Canterbury Park.

STRATEGIC USE OF RESOURCES

AGED's role in gambling oversight is a unique blend of law enforcement and regulatory work, and we recognize the difficulties the division faces in balancing its various responsibilities, particularly in a time of tight state budgets. Nevertheless, we found that:

- **AGED does not use its resources as strategically as it could.**

The division does not have well-articulated strategies to target its casino oversight activities. As discussed earlier, AGED has chosen to focus its inspection resources on testing of individual slot machines (and occasional observations of blackjack play). We think the division could, across the board, more fully utilize its authority. However, given limited resources, the division needs to be strategic in its inspection approach by tailoring its inspection activities to each casino's unique circumstances and by using available information to its best advantage. For example, as discussed earlier, the division could get a clearer picture of slot machine compliance by better using data from casinos' slot machine management systems.

AGED needs to use a risk-based approach to better target its casino inspections and background investigations.

AGED could also use a more risk-based approach in conducting background investigations. As we said earlier, we agree that background investigations must provide enough information on which to comfortably base licensing or contracting decisions; however, the goal of regulation is not to eliminate risk, but to minimize it. Accordingly, as a standard practice, investigators need to exercise reasonable judgment in defining the scope of a background investigation. For example, a Minnesota-based business that is subject to other government or professional oversight may require a less detailed investigation than a new business that has little regulatory history here or in other states. By varying the intensity of background investigations based on a risk assessment, the division could make more efficient use of its resources.

AGED managers have expressed similar concerns regarding the best use of the division's criminal investigation resources. AGED and the other regulatory agencies have not agreed on (1) gambling vulnerabilities that are most important to address statewide, such as insider pull-tab sales or dealer thefts at the Canterbury Park card club; (2) the types of cases that AGED should work to address these vulnerabilities; or (3) the cases that should be handled through other means, such as referral to local law enforcement offices or civil regulatory action. To date, AGED has relied on personal relationships with other agency regulators to encourage timely and appropriate referrals, but formally agreed upon protocols may be more effective. Referral of some cases, such as theft by pull-tab sellers, to local law enforcement offices may be especially appropriate in those localities that assess a local gambling tax on charitable gambling organizations. These taxes are, by law, supposed to be used to cover local regulation of charitable gambling.¹⁶

¹⁶ *Minn. Stat.* (2004), §349.213, subd. 3.

The division's ability to develop and implement a more strategic approach to its work depends heavily on staff capabilities, but we found that:

- **AGED staffing policies have hindered the division's effectiveness.**

As of November 2004, the AGED gambling enforcement group included 12 professional staff members (including supervisors, but excluding administrative assistants) and 3 vacant positions. A fourth position will be vacant by the end of the year when a supervisory special agent retires. As has been the division's policy for several years, all 12 of these staff are sworn peace officers (special agents), and for the most part, they serve as generalists moving among the division's various duties.¹⁷ All of the special agents who work on casino oversight, for example, do so only part-time. At one time, the division had a civilian employee doing casino-related work, but division managers decided that they wanted its non-administrative staff to be sworn officers to give maximum flexibility in assigning work—that is, that all division employees would be available to work criminal investigations.

AGED uses law enforcement officers to do work that may be better suited to staff with different professional backgrounds.

However, to some degree, employing only sworn officers and using them largely as generalists has hindered the division's effectiveness. For example, some agents have received specialized training in casino auditing, slot machine technology, and other aspects of casino management. However, because of staff realignments over the years, not all agents that have received this training are currently assigned to tribal gaming matters. AGED officials also told us that staff could use more specialized training, but added that budget constraints have made such training more difficult to obtain. In our opinion, few, if any, AGED staff who oversee casinos need to be sworn law enforcement officers. Over time, adding staff with different professional backgrounds may help the division expand its expertise. In addition, while having a law enforcement officer on the team can be a benefit when conducting a background investigation—particularly when seeking information from other law enforcement jurisdictions—not all background investigation work requires law enforcement skills. For example, having a background investigator with experience in corporate financial structures could be useful. We believe that AGED could use its existing staff positions more strategically by, over time, developing a more diverse skill set among its staff, and AGED managers agreed.

AGED managers are concerned that staff reductions over the past several years have left the division ill-positioned to do an effective job, and they have suggested two ways to increase available budget resources. First, AGED currently does not get fully reimbursed for costs associated with background investigations of Lottery vendors, and the division would like the law changed to require it.¹⁸ State law includes a mechanism for the division to be fully reimbursed by AGED,

¹⁷ According to AGED, at the peak of its staff complement in the mid-1990s, the division had 15 sworn officers (including the division director) and one auditor for gambling enforcement.

¹⁸ The Lottery does not license its vendors, but makes contracts contingent on successful completion of a background investigation. The Lottery reimburses AGED for some expenses, such as travel, but not for staffing costs associated with a background investigation.

Gambling Control Board, and Racing Commission license applicants.¹⁹ The law does not contain a similar mechanism for passing background investigation costs to Lottery vendors. Instead, reimbursement by these vendors is at the Lottery's discretion, which in the past, it has not chosen to exercise.

Second, the Commissioner of Public Safety can negotiate with tribal communities for an increase in the administrative fee paid by Minnesota's tribes. When the blackjack compacts were first negotiated, the 11 tribes agreed to pay a total of \$150,000 annually (\$13,636 each) to the state to offset the state's costs in administering the compact. This fee is contained in a compact section that can be amended by mutual agreement of the Commissioner of Public Safety and each tribe. With the tribes' cooperation and a well-justified plan showing how additional resources will be used, the state may be able to negotiate a larger payment.

CONCLUSIONS

The primary responsibility for ensuring that casinos operate with integrity rests with tribes. AGED has said that, in general, tribes manage and regulate slot machine and blackjack gambling in compliance with the compacts. While we have no basis to conclude that noncompliance has gone undetected, we have concluded that AGED inspection and oversight activities need to be improved. AGED would better serve the state, casino patrons, and tribes if it were to more fully use its authority to observe, evaluate, and test slot machine and blackjack play to assess compact compliance.

AGED makes important contributions to gambling integrity statewide, but could use its resources more effectively.

In addition to inspecting casinos, AGED investigators make important contributions to the integrity of gambling by conducting background investigations of potential licensees and investigating gambling crimes. Our evaluation, however, identified ways to fine-tune both investigative processes to improve effectiveness. Background investigations need to be thorough but timely, and we think the division can make its resources go farther by exercising professional judgment to adjust the scope and depth of investigations. Criminal law enforcement is an essential element in maintaining gambling's integrity. But again, the division could extend the impact of its work through collaborative agreements with the state's other gambling regulatory agencies that define criminal investigation priorities and protocols for handing off the right cases at the right time.

The gambling enforcement unit is a small group with a broad mission, and it needs to use its resources as effectively as possible. The division needs to adopt a more strategic approach. In both casino oversight and criminal investigations, for example, our work showed the need to develop clear regulatory goals that are based on known areas of concern and to target resources accordingly. In keeping with this strategic focus, the division will need to change its staff mix over time to

¹⁹ *Minn. Stat.* (2004), §§240.08, subd. 3; 349.151, subd. 8; and 349A.07. Under current law, AGED bills its licensees and Gambling Control Board licensees directly for the costs of background investigations. Businesses licensed by the Racing Commission reimburse the commission, which then transfers the funds to AGED.

include both law enforcement officers and staff with different professional backgrounds, particularly in the area of casino oversight.

RECOMMENDATIONS

Strengthen Casino Oversight

RECOMMENDATIONS

To provide well-justified, documented judgments regarding gambling compact compliance, the Alcohol and Gambling Enforcement Division should develop and implement a comprehensive oversight strategy that more fully utilizes the state's authority.

To address concerns that compact requirements for slot machine hardware and software are not up to date with current technology, the Commissioner of Public Safety should develop technical amendment proposals and discuss them with tribes.

To better track and target inspection activity, the Alcohol and Gambling Enforcement Division should develop and maintain a database or other systematic record of its casino inspection activity and results.

Within the bounds of the tribal-state gambling compacts, AGED managers agreed that the scope of the division's casino oversight activities should be expanded to more effectively assess compact compliance. To provide the most value, the division should consider how it could assess each casino's strengths and weaknesses, in terms of compact compliance, and target its activities accordingly. The division should capitalize on data from casinos' slot machine management information systems and other available information, such as internal and external audits. Developing a comprehensive oversight strategy is an important precursor to other recommended actions, including expanding AGED casino oversight staffing and initiating technical amendment discussions with the state's tribes.

The state and tribes share an interest in having clear regulatory standards. While negotiation must be a mutual process between the state and tribes, it is within our purview to make recommendations to the Commissioner of Public Safety—the sole designated authority for negotiating compact technical amendments on behalf of the state. In implementing this recommendation, AGED should focus its technical amendment proposals on the issues for which clearer standards are most needed. Tribal officials we interviewed emphasized that technical amendments need not be identical for all tribes.

One challenge we encountered during our review was lack of consistent, accurate data on the state's casino inspection activity. To track casino inspection activity, we had to compile information from letters, spreadsheets kept separately by various special agents, and other documents. The data were not standard, and some records had been lost. To document judgments regarding casino operations

and to facilitate systematic data analysis, the division should ensure that it has an accurate set of data on the dates, scope, and results of casino inspections.

Better Target Investigation Resources

RECOMMENDATIONS

To ensure that the division's resource investment is commensurate with the level of risk associated with the entity being investigated, the Alcohol and Gambling Enforcement Division should encourage background investigators to exercise professional judgment in planning the depth and scope of background investigations.

To better target criminal investigation resources and improve coordination, the Alcohol and Gambling Enforcement Division, Gambling Control Board, Racing Commission, and Lottery should:

- *Agree on law enforcement strategies that define the types of cases that should receive the highest priority and*
- *Develop written procedures for hand-off of cases for criminal investigation, including the timing of case referral and the circumstances in which criminal allegations will be referred to local law enforcement agencies.*

In addition, to improve communication among the agencies, the Alcohol and Gambling Enforcement Division, Gambling Control Board, and the Racing Commission should ensure that gambling enforcement agents assigned to each type of gambling have office space and a regular presence at the board and commission's offices.

While every background investigation must adequately support a licensing or contracting decision, not every background investigation needs to follow the same path. Regulators and other oversight authorities frequently make judgments regarding what areas to review and how deeply. We think that, to the extent possible, the division should do the same when conducting background investigations. Investigators should exercise professional judgment, reserving the most exhaustive investigations for those individuals or businesses that are new or have little other regulatory history, for which the investigator has an indication of problems, or for those that could have a significant impact on the integrity of gambling in the state.

AGED managers agreed that the division and the other regulatory agencies need to work collaboratively on compliance strategies that will help the division make the best use of its law enforcement resources. Although the Lottery currently does not refer criminal cases to AGED, it should be included in any discussions of statewide compliance priorities. The division needs to reach agreements with the Gambling Control Board, in particular, because charitable gambling accounts for most of the criminal referrals related to legal gambling. We think written protocols that articulate enforcement priorities and procedures for identifying and

handing off cases would bring more coherence to the criminal investigation process, both for targeting AGED resources and helping regulatory staff detect (and deter) crime in priority areas. To further make the best use of AGED resources, we believe that AGED should work with the Gambling Control Board to take advantage of local law enforcement resources in those communities that are charging licensed charitable gambling organizations a tax to support local government regulatory activities.

Relationships between AGED and regulatory agency investigators will continue to be important. To facilitate communication, case development, and case hand-off, we think it would be useful for AGED agents to have a regular presence at the Gambling Control Board and Racing Commission. As illustrated by misunderstandings regarding the division's oversight at the Canterbury Park card club, it is important that the division of responsibilities between AGED agents and the other agencies' compliance staff be well-defined and expectations for AGED special agents be clear.

Enhance Staff and Budget Resources

RECOMMENDATIONS

To increase its staffing capabilities, the Alcohol and Gambling Enforcement Division should:

- *Separate staffing for casino regulation from generalist special agents doing criminal or background investigation work,*
- *Hire staff with experience or expertise specific to casino regulation as opportunities become available, and*
- *Consider hiring other non-law enforcement staff to work on background investigations or as analysts supporting criminal investigation work.*

The Legislature should consider changing the law to allow AGED to directly bill all licensees or vendors for the cost of background investigations.

As part of technical amendment discussions with Minnesota Indian tribes, the Commissioner of Public Safety should pursue a technical amendment to the blackjack compacts that increases the fee tribes pay to the state to assist with state oversight.

AGED managers agreed that the division would benefit from adding other types of staff to its cadre of special agents. Expanding the division's casino-related staff expertise is, in our view, essential to more fully utilizing the division's oversight authority. We also believe that casino oversight staff should be dedicated to that work rather than functioning as gambling enforcement generalists, and division managers agreed. The division might also want to consider augmenting its staff with background investigation specialists and non-law enforcement analysts that would bring other specialized interests and skill sets to the division. AGED

officials have said that some of the division's special agents have little interest in regulatory work, including background investigations. We think it makes sense for the division to use its staff resources in the areas of work to which they are best suited, and in the case of special agents, that is often law enforcement.

To support its staffing plan, the division should pursue available funding options. These include having the subjects of background investigations pay the associated costs. As noted earlier, AGED has not been reimbursed for the full cost of background investigations of lottery vendors, and we think state law (*Minnesota Statutes*, section 349A.07, subd. 2) should clearly state that the relevant vendors do so. In addition, Minnesota Indian tribes agreed to provide funding for state oversight activity when the blackjack compacts were first negotiated, and the compact section establishing these payments is subject to amendment if mutually agreed upon by the Commissioner of Public Safety and a tribe. Before initiating discussions with tribes regarding higher payments, however, it is essential that the Commissioner have a plan that delineates how additional resources would be used.

Minnesota's Regulatory Approach

SUMMARY

Minnesota's gambling laws and regulatory approach have evolved as the scale and nature of legal gambling have changed, resulting in a segmented and specialized oversight structure. We identified a number of similar problems among several of Minnesota's regulatory agencies, including inadequate use of technology, limited strategic analysis, and insufficient staff expertise. However, we did not find a compelling case for consolidating gambling regulatory agencies. Many of the deficiencies we identified did not appear to result from the state's segmented approach to gambling oversight, nor would solutions necessarily result from consolidation. Still, addressing some challenges will require a cooperative, multi-agency response.

Minnesota has a segmented and specialized approach to state oversight of gambling.

Minnesota's approach to regulating gambling has evolved as the scale and nature of legal gambling have changed, resulting in a segmented and specialized oversight structure. In 1989, the Legislature tried a more unified approach and created the Department of Gaming to oversee lottery games, horse racing, and charitable gambling. However, gambling oversight continued to be compartmentalized within the agency, and on the recommendation of the Gaming Commissioner, the Legislature dissolved the agency in 1991.

As discussed in earlier chapters, the Gambling Control Board, Minnesota Racing Commission, Minnesota State Lottery, and Alcohol and Gambling Enforcement Division (AGED) each take a different approach to regulating gambling and have had varied degrees of success with gambling oversight. In this chapter, we address the following questions:

- **What common challenges affect Minnesota's gambling regulatory agencies?**
- **Is Minnesota's current regulatory structure reasonable?**

To answer these questions, we relied primarily on the results of our work at each of the four agencies, particularly our understanding of the vulnerabilities associated with each type of gambling, agencies' compliance strategies to address vulnerabilities, and problems we found in implementing these strategies.

COMMON PROBLEMS

We identified similar problems at some of the agencies we evaluated. Specifically, we found that:

- **Except at the Lottery, the agencies involved in gambling regulation make inadequate use of technology and strategic analysis and are hindered by staffing limitations.**

Outdated or limited use of technology by gambling regulatory agencies has created inefficiencies. For example, Racing Commission staff receive horse racing wager and payout data from paper reports, which they re-enter into their own system by hand. AGED agents keep casino inspection data inconsistently and on several laptop computers. Agencies transmit fingerprints to the Federal Bureau of Investigation in hardcopy rather than using electronic fingerprinting technology. Gambling Control Board staff keep data for licensing, compliance, and investigations on separate systems. In addition, Gambling Control Board staff have had limited electronic access to important data from the Department of Revenue. For the most part, only the Lottery uses sophisticated information technology to fulfill its responsibilities.

Better use of technology would improve gambling oversight in Minnesota.

In addition to process inefficiencies, insufficient use of technology means that agencies have missed opportunities to analyze data and to use this analysis to better target resources at specific areas of risk or noncompliance. For example, AGED agents do not fully use available casino-generated data to examine slot machine operations. Gambling Control Board compliance reviews are primarily scheduled based on the amount of time that has elapsed since an organization's last review, rather than targeted at organizations whose data show problem patterns. According to Racing Commission members, the staff could be more proactive in analyzing data to identify emerging compliance issues. For example, commission staff could systematically review Canterbury Park surveillance logs to identify common problems or trends in card club activity. In general, agencies do not use data to identify outliers or patterns that may indicate a problem.

Finally, in some cases, agencies have limited in-house expertise. AGED uses generalist special agents (sworn peace officers) to conduct casino inspections, with agents doing so on a part-time basis. Although some agents have received specialized, casino-related training, some of these agents are not assigned to tribal gaming matters. The Racing Commission does not have adequate in-house expertise to assess card club operations. Instead, the commission relies on the expertise of Canterbury Park, the organization they are responsible for regulating. Over time, these agencies need to develop an appropriate mix of staff resources and expertise. Once that occurs, the agencies can be more strategic in their gambling oversight.

REGULATORY STRUCTURE

In doing our work at the Gambling Control Board, the Racing Commission, the Lottery, and AGED, we considered whether the deficiencies or challenges we identified were the result of the state's segmented approach to gambling oversight and could be improved if oversight were consolidated. Overall, however, we found few problems resulting directly from the division of duties among agencies, and concluded that:

- **There is not a compelling case for consolidating Minnesota's gambling regulatory agencies, although there are some disadvantages to the current segmented structure.**

For the most part, we think the state's current approach is reasonable because the various types of gambling are quite distinct and require different forms of state involvement. Disadvantages that do exist could be addressed within the current regulatory structure.

As discussed throughout this report, each type of gambling operates very differently, requiring specialized knowledge on the part of regulators and different regulatory approaches. For example, the Lottery needs flexibility to operate the business of producing, distributing, and marketing lottery games. At the same time, horseracing and charitable gambling are very different types of gambling that require different oversight expertise. For example, horse racing oversight requires veterinarians, stewards, and other specialized and seasonal staff that need to be on site at the racetrack. In contrast, the Gambling Control Board requires staff with different expertise and a year-round field presence across the state. In addition, by the terms of tribal-state compacts, the state's oversight of blackjack and slot machine gambling at Indian casinos must reside in the Department of Public Safety, and the department is also the logical home for gambling-related law enforcement work. In the end, if the law required all four agencies to consolidate into one organization, this specialization would still be needed, and day-to-day regulatory activity would likely remain segmented as it did from 1989 to 1991 when consolidated in the state's Department of Gaming.

Division of responsibilities among agencies presents challenges—particularly at the policy level. For example, it is difficult to coordinate a statewide gambling policy and allocate resources accordingly under the current regulatory structure. There is no “ultimate authority” to decide when an investigation should move from civil to criminal jurisdiction. In addition, there is likely some administrative redundancy in the current structure, for example in processing licensing applications and fingerprints and providing technology support.

However, improved coordination among agencies could help address common challenges and other issues, resulting in improved gambling oversight overall. Specifically, we found that:

- **Opportunities exist to improve information sharing and coordination among agencies.**

Consolidation would not eliminate the need for specialization in gambling regulation and oversight.

Absent consolidation, agencies can work together to identify enforcement priorities and coordinate the transfer of cases from civil to criminal jurisdiction. They can also partner to share data and technology.

As discussed in Chapter 5, improving AGED's use of its investigative resources will require cooperation from other agencies. We found that to effectively target its resources and maximize the chance that investigations will lead to arrest and successful prosecution, the division needs to work with the other agencies to define compliance priorities and use these priorities to guide which cases should be referred to AGED and when. However, AGED cannot implement this targeted strategy on its own. The regulatory agencies need to communicate with AGED regarding allegations of criminal conduct that fit with these compliance priorities. The regulatory agencies also need to refer the cases at the right time and accept responsibility for regulatory action on those cases AGED and local law enforcement do not pursue.

Some disadvantages of having separate gambling oversight agencies could be addressed through improved interagency coordination.

As discussed earlier, inadequate use of technology is a common concern, and solutions may lie in a cooperative response. For example, communication between AGED and other agencies' compliance staff regarding criminal allegations would be easier if AGED agents could electronically access other agencies' case data. As discussed in Chapter 2, the Gambling Control Board needs to improve its use of data analysis to target its compliance activities, but much of the relevant data is held by the Department of Revenue. The board needs to continue working with the Department of Revenue to create a smooth information exchange. Finally, investing in and maintaining technology systems can be a resource challenge for small agencies. For the Racing Commission and Gambling Control Board, in particular, we think there are opportunities to share information technology support. Both agencies' directors have said that, given their tight budgets, neither can afford full-time technical support personnel. However, both agencies have a real need for improved technology systems that would ultimately allow them to work more efficiently and effectively.

CONCLUSIONS

As we have discussed throughout this report, Minnesota's legal gambling industries are diverse, and the laws governing their regulation are complex. We found that the state's gambling regulatory agencies engage in oversight activities suited to their respective types of gambling, but they have had varying degrees of success in protecting game integrity. Our work shows that, in general, agencies need to more proactively identify and prioritize compliance problems and vulnerabilities, then target resources accordingly. But, the agencies will be challenged in doing so by technology limitations, data access problems, and gaps in staff expertise. We do not, however, think that consolidating some or all of the agencies is a necessary solution to these challenges or other problems we identified. Segmented gambling regulation has some disadvantages, but overall, we concluded that the current structure makes sense given the unique features of each type of gambling.

Summary of Recommendations

Gambling Control Board (pp. 41-45)

To fully comply with statutory licensing criteria, the Gambling Control Board should:

- At initial licensure and periodically thereafter, expand background checks of gambling managers to include their criminal records outside Minnesota and
- Conduct background checks on all individuals whose positions within an organization make their criminal history grounds for denying an organization license.

As directed by statute, the Gambling Control Board should:

- Develop standards for the percentage of total expenditures that licensed 501(c)(3) organizations may spend on administration and operation.

To better detect and deter noncompliant charitable gambling activities, the Gambling Control Board should:

- Increase charitable gambling education opportunities, to the extent possible;
- Create education requirements for gambling organizations' chief executive officers;
- Use its citation authority more frequently in instances of organization noncompliance;
- Continue to strive for consistency in issuing citations;
- Target some of its compliance reviews to organizations that show signs of problems; and
- Increase the use of site inspections, to the extent possible.

To improve the efficiency and effectiveness of its regulatory activities, the Gambling Control Board should:

- Improve its technology to facilitate access to data, quantitative analysis, and online licensing and reporting.

To improve oversight of gambling proceeds, the Legislature should:

- Consider amending statutes to clarify (1) the applicable timeframe for gambling business spending limits and (2) the extent to which organizations can use non-gambling funds to support their gambling operations.

To help organizations comply with the law and to ease board regulation, the Gambling Control Board should:

- Identify lawful purpose definitions that need to be clarified and submit statutory changes to the Legislature.

To help the Gambling Control Board use its resources effectively, the Legislature should:

- Reconsider the scope and focus of the Gambling Control Board's responsibilities in regulating charitable gambling.

Minnesota Racing Commission (pp. 60-63)

To ensure that the Racing Commission licenses only eligible applicants, the commission should:

- Consider obtaining an electronic fingerprinting system to shorten the turn-around time for receiving criminal history information.

To improve oversight of the card club, the Racing Commission should:

- Have a trained, knowledgeable, and regular presence in the surveillance room;
- Conduct routine compliance checks of card club activities;
- Regularly review players' pool expenditures; and
- Review all promotions using players' pool funds.

To ensure that the proper amount is allocated to horseracing purses, the Racing Commission should:

- Conduct periodic reviews of Canterbury Park's purse contributions.

To ensure that it can comfortably rely on information provided by Autotote, the Racing Commission should:

- Require regular and comprehensive audits of Autotote's information systems that meet industry standards for information technology security audits.

To more efficiently use its resources, the Racing Commission should:

- Make the necessary investments to automatically download the pari-mutuel wager information from Autotote and
- Revise its current technology systems so staff do not manually enter the same data into the system more than once.

Minnesota State Lottery (pp. 75-77)

To ensure that scratch games are adequately tested prior to being played, the Minnesota State Lottery should:

- Require that the scratch game ticket security test conducted by an independent laboratory be completed and the results reported in writing to the Lottery prior to the launch of the game.

To protect the physical security of scratch game tickets and effectively use its resources, the Minnesota State Lottery should:

- Determine if its internal scratch game ticket testing materially adds to the security of a game, revise its written procedures to be consistent with its assessment of the usefulness of the internal security tests, and follow its written procedures.

To ensure that it has secure and reliable information technology systems, the Minnesota State Lottery should:

- Have regular, comprehensive audits of its information systems that meet industry standards for information technology audits.

To fully comply with statutory background check requirements, the Minnesota State Lottery should, when initially entering into a retailer contract and periodically thereafter:

- Expand background checks of retailers to include their criminal records outside of Minnesota.

Alcohol and Gambling Enforcement Division (pp. 98-101)

To provide well-justified, documented judgments regarding Indian casinos' compliance with tribal-state gambling compacts, the Alcohol and Gambling Enforcement Division should:

- Develop and implement a comprehensive oversight strategy that more fully utilizes the state's authority.

To address concerns that tribal-state compact requirements for slot machine hardware and software are not up to date with current technology, the Commissioner of Public Safety should:

- Develop technical amendment proposals and discuss them with tribes.

To better track and target casino inspection activity, the Alcohol and Gambling Enforcement Division should:

- Develop and maintain a database or other systematic record of its casino inspection activity and results.

To ensure that the division's background investigation resource investment is commensurate with the level of risk associated with the entity being investigated, the Alcohol and Gambling Enforcement Division should:

- Encourage background investigators to exercise professional judgment in planning the depth and scope of background investigations.

To better target criminal investigation resources and improve coordination, the Alcohol and Gambling Enforcement Division, Gambling Control Board, Racing Commission, and Lottery should:

- Agree on law enforcement strategies that define the types of cases that should receive the highest priority and
- Develop written procedures for hand-off of cases for criminal investigation, including the timing of case referral and the circumstances in which criminal allegations will be referred to local law enforcement agencies.

To improve communication among the agencies, the Alcohol and Gambling Enforcement Division, Gambling Control Board, and the Racing Commission should:

- Ensure that gambling enforcement agents assigned to each type of gambling have office space and a regular presence at the board and commission's offices.

To increase its staffing capabilities, the Alcohol and Gambling Enforcement Division should:

- Separate staffing for casino regulation from generalist special agents doing criminal or background investigation work,
- Hire staff with experience or expertise specific to casino regulation as opportunities become available, and
- Consider hiring other non-law enforcement staff to work on background investigations or as analysts supporting criminal investigation work.

To increase the division's budget resources:

- The Legislature should change the law to allow the Alcohol and Gambling Enforcement Division to directly bill all licensees or vendors for the cost of background investigations; and
- The Commissioner of Public Safety should pursue a technical amendment to the tribal-state blackjack compacts that increases the fee tribes pay to the state to assist with state oversight.

Further Reading

Ader, Jason A. and Marc J. Falcone. *Bear Stearns North American Gaming Almanac, 2003-2004*. Las Vegas, NV: Huntington Press, 2004.

Meister, Alan. *Indian Gaming Industry Report*. Newton, MA: Casino City Press and Analysis Group, Inc., 2004.

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Minnesota Gambling Control Board

Suite 300 South
1711 West County Rd B
Roseville, MN 55113
651-639-4000

December 29, 2004

Mr. James Nobles
Office of the Legislative Auditor
658 Cedar Street
Centennial Office Building – 140
St Paul, MN 55155

Dear Mr. Nobles:

Thank you for the opportunity to respond to your evaluation report involving the regulation of gambling in Minnesota. Please extend my thanks to your staff for their thorough analysis and hard work to complete this evaluation. The evaluation pertaining to the responsibilities of the Gambling Control Board covered a wide range of issues involving lawful (charitable) gambling and confirms the complexity of regulating this huge, cash-based industry.

The report supports the Gambling Control Board's efforts for maintaining the integrity and security of the games but also recognizes the limited oversight of the licensed charitable organizations. A concern of the Board and supported by your evaluation, is the limited resources available for regulatory oversight of lawful gambling. The recommendations in your report will help facilitate changes and foster discussions with the Legislature involving the focus of responsibilities for regulating lawful gambling in Minnesota.

Many of the recommendations identified in the report have already been acted on or included in the Board's legislative initiatives for consideration during the 2005 session. The Board is also aggressively moving forward this fiscal year with the implementation of a new information system that will improve efficiencies for compliance review and licensing of non-profit organizations.

Again, thank you for your efforts and the constructive recommendations in the report.

Sincerely,

/s/ Tom Barrett

Tom Barrett
Executive Director



MINNESOTA RACING COMMISSION

P.O. Box 630
Shakopee, Minnesota 55379
Telephone: 952-496-7950
Fax: 952-496-7954

December 28, 2004

Mr. James R. Nobles
Legislative Auditor
100 Centennial Office Building
658 Cedar Street
St. Paul, MN 55155

Dear Mr. Nobles,

The Minnesota Racing Commission sincerely appreciates the work of the staff of the Office of the Legislative Auditor. Throughout this engagement, your staff conducted themselves with a high degree of professionalism and respect toward Commission staff in recognizing the importance of our activities regarding these forms of gaming.

In response to the recommendations contained in the report, there is nothing here that surprises us. All of the recommendations have at one time or another been discussed by staff and in some cases have been documented as needs of this Commission.

For instance, the recommendation regarding streamlining our licensing procedures has been a desire of mine for about the last three to four years when we became aware that the FBI was moving toward electronic scanning of an individual's fingerprints. As your staff knows, that is now online. We have been informed, by the Alcohol and Gambling Enforcement Division of the Department of Public Safety, that as of next August they will be able to process scanned fingerprints. We will need to purchase the necessary scanning equipment and have included that as an initiative for the Governor's '06-'07 Biennial Budget.

The recommendation regarding expanding the oversight of the card club can be responded to by saying that we have done the best that we were and are able to under the funding restraints that have been in place during the two previous biennia. Five years ago when we began working on the racetrack's plan of operation we did not hire additional personnel at that time and have not added staff since. The public policy on spending during that time was to hold the line on spending, and that meant all spending, not just the general fund. Commission staff does maintain a limited presence in the surveillance room, reviews daily report logs of both surveillance and security, and reviews players' pool promotional proposals. We have not performed a recent test of card room procedures. A review of the plan of operation and its internal controls was done during 2001. With the popularity of poker increasing enormously over the past two years, there

is a need to increase our staffing in this area. That recommendation will be pursued with the Commission.

Passage of the card club legislation has accomplished exactly what the Legislature intended; that the horse racing industry be improved by improving purses. However, in that regard we have not focused on the need to periodically have Commission staff perform an audit of the purse account as there are other indicators that would disclose any potential problems with the racetrack's management of this account. For instance the racetrack and the Minnesota Horsemen's Benevolent and Protective Association (HBPA) annually negotiate, during the fall, their contract for the next live race meet, which includes purses. At no time has that process been brought to the Commission alleging that there may be a problem or irregularity in purse amounts. As well, as required by the card club legislation, we annually review the card club financial reports with the racetrack and members of the Board of Directors of the HBPA to be sure that the card club revenues are being used for the purpose intended by the Legislature. Those meetings have not disclosed any problems with the purse account management or amounts. Those meetings are based on the audited financial report that must be provided to the Commission on an annual basis. Those audit reports have not disclosed any problems or questions regarding the management of the purse account. But having said that, I can understand where this recommendation is coming from and will work with current Commission staff in developing periodic audit procedures and reporting to satisfy that recommendation.

The recommendation regarding tote reliability and improving technology use falls entirely outside the capability of the Commission's current staff. We do not have on staff a trained, professional information technologist. To acquire that capability, the Commission will need additional staff resources to implement this recommendation.

Much like Powerball, simulcasting of races from other racetracks is a multi-state game. In that regard we rely on our colleagues in other states to assist us in assuring the integrity of racing and pari-mutuel betting. Many of those state commissions have more staff and more technology staff to review the tote standards and security.

The two recommendations regarding automatic downloading of tote information and eliminating the redundancy of data entry for the pari-mutuel auditing system and the breeders' fund system have been discussed many times by me and other Commission staff. To accomplish these goals will require a significant programming effort that we are not capable of doing nor have we had the financial resources available for this effort. In our Strategic Information Resources Management Plan that was submitted to the Office of Technology in April, 2001, we did include the updating and integration of the pari-mutuel system and the breeders' fund system at a cost estimated at \$20,000-\$25,000. So this is an enhancement that we have been and remain aware of but funding has been the hurdle to overcome. It would be appreciated by us if the Auditor's Office could assist us in pursuing the possibility of perhaps sharing with another small agency the services of trained, professional information systems specialist or manager.

Soon, these recommendations will be discussed with the Commission to gain their insights for recommendation and resolution. I feel confident that their expectations as to the regulatory oversight have been met despite the financial and staffing limitations that we have endured over the past biennia. But, we will need support from the Legislature to adequately satisfy all of the recommendations.

Again I want to express my appreciation to you and your staff in the work that you have done and the approach that was taken. This report will hopefully support enhancements to our regulatory and enforcement oversight thereby furthering our ability to accomplish the goals of the pari-mutuel horse racing law and the card club law.

With Sincerest Regards,

/s/ Richard G. Krueger

Richard G. Krueger
Executive Director

c: Racing Commission Members



January 3, 2005

Mr. James Nobles, Legislative Auditor
Office of the Legislative Auditor
Centennial Building, Room 140
St. Paul, Minnesota 55155

Dear Mr. Nobles:

Thank you for the opportunity to respond to your evaluation report: "Gambling Regulation and Oversight." We appreciate the hard work and analysis that went into this report.

The report recognizes the complexity of the subject matter and the extensive and comprehensive measures undertaken by the Lottery to ensure the security and integrity of lottery games. While the report sets forth a few recommendations directed to the Lottery, none of them reflects adversely on the Lottery's efforts to ensure the integrity and security of its games.

The Lottery agrees with three of the recommendations in the report directed to the Lottery and has already begun implementation. The Lottery has implemented procedures to ensure that the results of security tests conducted on Scratch Games by an independent laboratory are reported in writing to the Lottery prior to the launch of that game, and that Lottery personnel follow adopted written procedures relating to Scratch Game ticket testing. Further, a comprehensive information security audit is currently being conducted on the Lottery's information systems and annual audits will be conducted hereafter.

As to the last recommendation directed to the Lottery, the Lottery currently conducts criminal history checks in Minnesota on all retailers which provides some assurance that retailers do not have a criminal history. While the OLA believes that national checks should be used to ensure that the Lottery meets the intent of the law by providing a more thorough assurance that a retailer does not have a criminal history, to expand this check nationwide is not cost-effective and would have no appreciable effect on the security of lottery games. First, unlike persons licensed by the Gambling Control Board and the Racing Commission who can directly affect the integrity of their games, retailers selling lottery tickets pose little or no threat to the integrity or security of any game. Second, to conduct national checks on the owners and officers of each of the more than 3,000 retailers selling lottery tickets in Minnesota would cost the Lottery in excess of \$250,000 a year (with comparable costs on the part of individual retailers), with little or no benefit to the integrity and security of lottery games.

Again, we would like to thank you for the opportunity to comment on this report.

Sincerely,

A handwritten signature in cursive script that reads "Clint Harris".

Clint Harris
Executive Director

MINNESOTA DEPARTMENT OF PUBLIC SAFETY



Office of the Commissioner

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December 29, 2004

Mr. James Nobles
Legislative Auditor
Office of the Legislative Auditor
Room 140, Centennial Office Building
658 Cedar Street
St. Paul, MN 55155

Dear Mr. Nobles:

Thank you for your thoughtful and thorough review of the Alcohol and Gambling Enforcement Divisions (AGED) work relating to casino oversight, division resources and background and criminal investigations. The Department appreciates the legislature's interest in the delicate balance of gambling oversight and enforcement throughout Minnesota.

Since the inception of AGED, we have worked to fulfill our statutory obligations to the citizens of the state by keeping lawful forms of gambling fair and vigorously investigating those individuals trying to illegally profit from gambling. As evidenced by the absence of any major controversies, the historical growth of the industry and the financial resources allotted in 1989, we believe that AGED has done a good job.

However, your report does identify some areas of concern and we appreciate the recommendations you have made. AGED has already begun developing a comprehensive strategy for casino oversight and will develop a standardized casino inspection that better uses the authorities afforded us by the gaming compacts. AGED has also initiated a meeting of the Gambling Control Board, Lottery and Racing Commission for the purpose of developing the policies and procedures relating to the administration of criminal investigations.

The audit recommendation to move from generalist agents to specialized agents will be implemented as it is more consistent with other divisions within the Department of Public Safety.

We appreciate your recognition of the need for enhanced training of the division's agents and for the recommendation to the legislature to allow us to directly bill all licensees or vendors for the full cost of background investigations.

Thank you for the opportunity to review the *Gambling Regulation and Oversight Report*. The Department of Public Safety will work to fully and completely implement the constructive recommendations and the identified procedural changes.

Sincerely,

/s/ Michael Campion

Michael Campion
Commissioner

Alcohol &
Gambling
Enforcement

Bureau of
Criminal
Apprehension

Capitol Security

Driver & Vehicle
Services

Emergency
Management/
Emergency
Response
Commission

Office of
Homeland
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<i>Transit Services</i> , February 1998	98-03	<i>Preserving Housing: A Best Practices Review</i> , April 2003	03-05
<i>State Building Maintenance</i> , February 1998	98-04	<i>Charter School Financial Accountability</i> , June 2003	03-06
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<i>Early Childhood Education Programs</i> , January 2001	01-01		
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